MINING RECLAMATION RESERVE BILLS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 1911 and S. 2642

DECEMBER 7, 1982

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MINING RECLAMATION RESERVE BILLS

TUESDAY, DECEMBER 7, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Malcolm Wallop (chairman) presiding.

Present: Senators Wallop, Symms, and Heinz.

[The committee press release announcing hearing, the Joint Committee on Taxation's description of S. 1911 and S. 2642 and the prepared statements of Senators Wallop and Heflin follow:]

Press Release No. 82-172

PRESS RELEASE

FOR IMMEDIATE RELEASE
November 3, 1982

UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Energy
and Agricultural Taxation
2227 Dirksen Senate Office
Building

FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
RESCHEDULES HEARING ON MINING RECLAMATION RESERVE BILLS

Senator Malcolm Wallop, Chairman of the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance, announced today that the Subcommittee has rescheduled its previously postponed hearing on S. 1911 and S. 2642 for Tuesday, December 7, 1982 at 10:00 a.m. S. 1911 and S. 2642 deal with the tax treatment of mining reclamation reserves.

Requests to testify.--Witnesses who previously submitted requests to testify need not send a request for rescheduled date. Other persons who desire to testify at the hearing on December 7, 1982, must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, to be received not later than Tuesday, November 30, 1982. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such a case, a witness should notify the Committee as soon as possible of his inability to appear.

Legislative Reorganization Act.--Senator Wallop stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

DESCRIPTION OF TAX BILLS
(S. 1911 and S. 2642)

Relating to

ACCOUNTING FOR MINING RECLAMATION RESERVES

Scheduled for a Hearing

Before the

Subcommittee on Energy and Agricultural Taxation

of the

Senate Committee on Finance

on December 7, 1982

Prepared by the Staff

of the

Joint Committee on Taxation

December 3, 1982

JCX-47-82

INTRODUCTION

The bills described in this document are scheduled for a hearing on Tuesday, December 7, 1982, before the Senate Finance Subcommittee on Energy and Agricultural Taxation. There are two bills scheduled for the hearing: (1) S. 1911 and (2) S. 2642 (both relating to the accounting for mining reclamation reserves).

The first part of the document is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1911[1] - Senators Specter and Byrd (W. Va.)

The Mining Reclamation Reserve Act of 1981

The Surface Mining Control and Reclamation Act of 1977 and similar State laws require surface mine operators to restore land that is disturbed by the mining process. Present law is unclear as to when surface mining reclamation expenses may be accrued.

S. 1911 would provide that a taxpayer may elect, on a property-by-property basis, to deduct the estimated expenses of surface mining reclamation ratably over the life of the mine. Cash basis taxpayers would be permitted to elect this method of accounting for reclamation costs.

The provisions of this bill would apply to taxable years ending after the date of the enactment of this Act.

2. S. 2642 - Senators Wallop and Symms

The Comprehensive Mining Reclamation Reserve Act of 1982

The Surface Mining Control and Reclamation Act of 1977 and similar State laws require surface mine operators to restore land that is disturbed by the mining process. Present law is unclear as to when surface mining reclamation expenses may be accrued.

S. 2642 would provide that a taxpayer may elect, on a property-by-property basis, to deduct the estimated expenses of surface mining reclamation either ratably over the life of the mine or in the year the land is disturbed. Cash basis taxpayers would be permitted to elect to use either of these methods of accounting for reclamation costs.

The provisions of this bill would apply to taxable years ending after the date of the enactment of this Act.

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[1] S. 1911 is substantially similar to H.R. 4815 introduced by Congressmen Bailey (Pa.) and Murphy.

II. DESCRIPTION OF TAX BILLS

1. S. 1911 - Senators Specter and Byrd (W. Va.)
The Mining Reclamation Reserve Act of 1981

2. S. 2642 - Senators Wallop and Symms
The Comprehensive Mining Reclamation Reserve Act of 1982

Present law

The Surface Mining Control and Reclamation Act of 1977 and similar State laws impose specific reclamation requirements on surface mine operators. Mine operators must guarantee their compliance with these requirements by posting bonds or otherwise proving their financial responsibility. The time at which reclamation expenses may be deducted in computing taxable income is determined under the generally applicable tax rules. Thus, for a taxpayer using the cash method of accounting, these expenses may be deducted when paid. For an accrual method taxpayer, items may be deducted in the year in which all events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. When surface mining reclamation expenses may be accrued under the general rules for accrual is unclear.

Prior to 1978, the mining industry assumed that a surface mining operator should accrue the estimated expenses of reclamation as mining operations progressed. This assumption was based primarily on the court decisions in Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951) and Denise Coal Co. v. Commissioner, 271 F.2d 930 (3rd Cir. 1959) which permitted State-mandated reclamation expenses to be accrued as mineral was extracted. In 1978, the Internal Revenue Service issued a private letter ruling which did not follow the Harrold and Denise line of cases. This private letter ruling stated that reclamation expenses cannot be accrued until the year in which reclamation occurs. Since then, the Tax Court has decided Ohio River Collieries v. Commissioner, 77 T.C. 1369 (1981). In that case, the court held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed.

Issues

The first issue is whether the costs should be deducted (a) in the year the land is disturbed, (b) as minerals are extracted or (c) when the reclamation occurs.

The second issue is whether the taxpayer should be given the opportunity to elect which of the three methods to use (i.e., to deduct the costs when the land is disturbed, the minerals extracted or the reclamation occurs) and whether the election should be on a property-by-property basis or should apply to all properties consistently.

The third issue is whether cash basis taxpayers should be permitted to elect to use these methods for reclamation costs.

Explanation

General

Both bills would allow a taxpayer engaged in surface mining to elect, on a property-by-property basis, to deduct in computing its taxable income a reasonable addition to reserves established for the estimated expenses of surface mining land reclamation. Estimated expenses would be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted ratably over the life of the mine. S. 2642 would also allow the taxpayer to elect to allocate estimated expenses to the property rather than to production. In this instance, the accrued reclamation expenses would be deducted, to the extent of disturbance, in the year that the portion of the land is disturbed. Under both bills, cash basis taxpayers would be allowed to use the accrual method for reclamation costs. These bills do not affect the tax treatment of expenditures for the extraction of oil or gas, or for the extraction of minerals from brines or seawater.

Estimated expenses

Estimated expenses of surface mining land reclamation are amounts deductible by the taxpayer under the income tax rules that (1) are attributable to qualified reclamation activities (as defined in the bill) to be conducted in future taxable years, (2) are subject to estimation with reasonable accuracy, and (3) are allocable to minerals extracted before the end of the taxable year. In addition, S. 2642 permits the taxpayer the option of allocating estimated expenses on the basis of the portion of the property disturbed by surface mining rather than on the basis of minerals extracted. Taxpayers could elect to use different methods for different properties.

Qualified reclamation activities are defined as land reclamation activities conducted under a reclamation plan submitted as part of a surface coal mining permit application under the Surface Mining Control and Reclamation Act of 1977 or under a plan submitted pursuant to a Federal or State law imposing substantially similar surface mining land reclamation requirements. Thus, a qualifying plan would have to have been submitted to obtain a surface mining permit and would include the items specified in section 508 of the Surface Mining Control and Reclamation Act of 1977. If the reclamation plan is revised, only the activities described in the revised plan are subject to the reserve provision.

Nonqualified land reclamation expenses (i.e., expenses for reclamation activities other than those described in the plan) would be deductible in the manner prescribed by regulations.

Excessive reserve for estimated expenses

The bills also provide that if the amount in any reserve for estimated expenses of surface mining land reclamation is determined to be excessive at the close of any taxable year, then the excess shall be taken into account in computing taxable income for that year. Thus, if at the conclusion of reclamation activities the reserves were not entirely expended, the excess would be included in the taxpayer's income for that year unless the excess resulted from an unreasonable addition to the reserve in a prior year, in which case the prior year's income would be increased.

Elections

The provisions of the bills are elective on a property-by-property basis. A taxpayer may elect reserve accounting without the consent of the Secretary if the election is made not later than the time for filing the income tax return of the first taxable year ending after enactment in which the taxpayer is engaged in surface mining on the property and for which there are estimated expenses of surface mining land reclamation. Consent of the Secretary is required to elect reserve accounting beginning in any taxable year after the first post-enactment taxable year in which the taxpayer is engaged in mining on a property and has estimated reclamation expenses. The consent of the Secretary is also required to terminate the reserve accounting election. Furthermore, the provision in S. 2642 to allocate estimated costs to the property as overburden is removed rather than to the minerals extracted is elective on a property-by-property basis.

Transition rules

Estimated expenses of surface mining and reclamation that are attributable to mining activities occurring before the first taxable year for which reserve accounting is elected and which have not been previously deducted are treated as deferred expenses and may be deducted ratably over a 60-month period beginning the first month of the first taxable year for which reserve accounting is elected. If mining of a property with respect to which there are deferred expenses will be completed in less than 60 months, then the expenses can be deducted ratably over that shorter period. If any amount deducted under this 60-month rule is determined to be excessive, then under the general rules, that amount will be taken into account in computing the taxpayer's taxable income for the year in which the excess is determined.

The bills provide that if a taxpayer elects reserve accounting for the first taxable year ending after enactment and has used an accrual method of accounting, which resulted in a deduction for the reclamation expenses prior to the taxable year in which the expenses were paid, for a continuous period of one or more taxable years ending before enactment, then the taxpayer may elect to have that method treated as a valid method of accounting for that period. This election can be made with respect to only one such continuous period.

Effective date

The provisions of these bills would apply to taxable years ending after the date of the enactment of this Act.

Revenue effect

S. 1911 would reduce fiscal year budget receipts by less than $5 million annually for the fiscal years 1983 through 1987.

S. 2642 would reduce fiscal year budget receipts by $15 million in fiscal year 1983, $6 million in 1984, and $5 million annually in 1985, 1986, and 1987.

STATEMENT OF SENATOR MALCOLM WALLOP, CHAIRMAN
SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
DECEMBER 7, 1982

The purpose of this hearing this morning is to receive testimony on two bills concerning the timing of tax deductions for mining reclamation expenses. The first bill, S. 1911 was introduced by my colleague Senator Specter, with companion legislation being introduced by Congressman Bailey in the House. We will be hearing from both Senator Specter and Congressman Bailey this morning, and I would like to take this opportunity to both recognize and commend them for their efforts in this area. The second bill, S. 2642, was introduced by Senator Symms and myself in June of this year. That legislation is essentially identical to that offered by Senator Specter with the exception that it also includes a codification of what is known as the "as disturbed" method of accruing mining reclamation expenses.

Historically, the mining industry has relied on court cases from the 3rd and 4th circuits in determining how to accrue the estimated expenses of reclamation. That determination was that a surface mining operator should accrue the estimated expenses of reclamation as the mining operations progressed. In 1978, some twenty years after those decisions, the Treasury Department issued a private letter ruling which departed from those earlier cases. Needless to say that ruling was not openly embraced by the mining industry and brought on further litigation. A recent decision in what is known as the Chio River Collieries case reestablished the earlier precedents with a finding that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the

overburden was removed, thereby upholding the "as disturbed" method of accruing reclamation expenses. The legislation we are considering today would codify that decision.

It is clear from the Surface Mining Control and Reclamation Act of 1977 as well as legislation passed by many states, that there is a clear obligation for surface mining operators to reclaim the land they disturb during the mining process. Indeed, mining operators must guarantee they will comply with those reclamation laws by posting bonds with the states to cover the costs of reclaiming the land. The real core of what is at issue here today stems from the regulations which accompany section 461 of the tax code. That regulation states that "an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." It is the contention of the mining industry that those conditions are met during the course of the mining process rather than when those expenses may be actually incurred. Their position appears to carry with it the weight of judicial decisions on the subject.

It is my understanding that the Treasury Department may have other concerns which go beyond the scope of this hearing, but which, on the basis of the precedential value of this legislation may have significant ramifications in other areas of tax law. I am looking forward to those comments and a discussion of their merits by the representatives of the mining industry who will be appearing before the subcommittee this morning.

Fact Sheet - Mining Reclamation Hearing

Issue - the principle issue dealt with in your and Senator Specter's bill is that of the timing of the deductibility of reclamation expenses. There are three basic alternatives.

1. allow the deduction in the year when the land is disturbed (Wallop bill)-- This is what is known as accruing reclamation expenses on the "as disturbed" basis. The position is supported by a recent tax court case known as the Ohio River Collieries case. The rationale for the decision is based on an internal revenue code regulation which provides that an expense is deductible in the year in which all of the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. The test is satisfied in this case because the liability to reclaim is mandated by law (both state and federal) at the time the overburden stripping begins and the future reclamation expenses can be determined with reasonable accuracy by engineering analysis.

2. allow the deduction as the minerals are extracted (Wallop and Specter bill)-- The same rationale as stated above applies here except that instead of taking the deductions when the land is disturbed, the deductions are taken as the minerals are extracted.

3. allow the deductions when the reclamation actually occurs -- this allows no accruals and would basically put the taxpayer as the same position as a cash basis taxpayer - you take your deductions when you pay expenses.

Arguments
In favor of bills - the expense of reclamation is an identified expense of mining the coal and it is an expense which must be taken into account when determining the price of the coal - the expense should thus be identified and taken during the mining process rather than at the end of the process.

Treasury position --- as a practical matter Treasury isn't all that concerned about the mining industry using accrual methods to account for their reclamation expenses. What does concern them is the generic problem of accruing expenses for tax purposes. It is a problem which I think has merit. Example: A steel company decides to close a plant, but under the labor contracts they have they continue to be responsible for pensions and medical expenses which may continue for forty or fifty years. Pursuant to the accrual test, the liability is in fact certain and it can probably be reasonably estimated by actuarial calculations. If they are allowed a current deduction for all of those future expenses, the time value of those current deductions means that the Treasury may well end up paying all of the expenses and the steel company could possibly make a profit (on the deduction). It is also a problem with regard to insurance company settlements where a company will enter into an agreement to pay a person x amount of dollars over the lifetime of the person but takes a current deduction for the entire amount.

Other issues --- the timing of the reclamation expenses is a very important economic issue for the mining industry. The case they need to make is that the mining industry can be distinguished from these other industries, and thereby should be afforded immediate accural of those expenses. They can be distinguished somewhat on the basis of the fact that the reclamation is mandated by federal and state law.

The revenue loss on your bill is set at (in millions) 15, 6, 5, 5, and 5. It is difficult to see how any revenue loss can be assigned when all your legislation is doing is codifying an existing tax court decision.

TESTIMONY TO BE PRESENTED BY
U. S. SENATOR HOWELL HEFLIN
BEFORE THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
U. S. SENATE COMMITTEE ON FINANCE
DECEMBER 7, 1982
10:00 A.M.

MR. CHAIRMAN:

I HAVE BEEN ADDED AS A COSPONSOR TO S. 2642, THE "COMPREHENSIVE MINING RECLAMATION RESERVE ACT OF 1982," INTRODUCED BY SENATOR WALLOP (FOR HIMSELF AND SENATOR SYMMS). AS YOU ARE WELL AWARE BY NOW, THIS IS A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE FOR THE ESTABLISHMENT OF RESERVES FOR MINING LAND RECLAMATION AND FOR THE DEDUCTION OF AMOUNTS ADDED TO SUCH RESERVES.

MR. CHAIRMAN, IT IS NO SECRET THAT THE TAX ACCOUNTING OPTIONS AVAILABLE TO THE SURFACE MINING OPERATOR HAVE BEEN IN DISPUTE FOR MORE THAN 30 YEARS. THE PIVOTAL QUESTION SURROUNDING THE CONTROVERSY FOCUSES ON WHEN TO TAKE THE DEDUCTION FOR RECLAMATION AND RESURFACING COSTS -- IN THE YEAR IN WHICH ALL THE EVENTS FIXING THE FACT OF LIABILITY TO RECLAIM THE LAND OCCURRED OR THE YEAR IN WHICH THE RECLAMATION WORK WAS ACTUALLY PERFORMED.

RECENT CASE LAW -- ESPECIALLY Ohio River Collieries Co. v. Commissioner 77 T.C. No. 103 (Dec. 31, 1981) -- IN MY JUDGMENT, HAS SETTLED THE CONTROVERSY. HOWEVER, IT IS ALLEGED THAT THE INTERNAL REVENUE SERVICE REFUSES TO CHANGE ITS POSITION IN LIGHT OF CURRENT CASE LAW. HEREIN LIES THE REAL REASON FOR S. 2642.

ACCORDING TO THE AFOREMENTIONED RECENT CASE LAW, LIABILITY OF THE TAXPAYER/SURFACE MINING OWNER TO RECLAIM THE AFFECTED LAND BECOMES FIXED AS SOON AS THE SURFACE MINING BEGINS. THE ONLY REMAINING ISSUE THEN BECOMES THE DETERMINATION OF THE AMOUNT OF THE REQUIRED RECLAMATION EXPENSE OR A REASONABLE ESTIMATE THEREOF. THIS IS WHERE,

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I UNDERSTAND, THAT THE INTERNAL REVENUE SERVICE LIKES TO FLEX ITS MUSCLES. HOWEVER, IF THE TAXPAYER/SURFACE MINING OWNER DOES ITS HOMEWORK IN THE EXEMPLARY MANNER AS THE OHIO RIVER COLLIERIES COMPANY, THE SAME FAVORABLE RESULT SHOULD ENSUE.

THE LEGISLATION OF WHICH I AM A COSPONSOR, S. 2642, IS DESIGNED TO ASSURE THE TAXPAYERS/SURFACE MINER OWNERS THAT THEY WILL BE ABLE TO UTILIZE THE CASE-LAW PRESCRIBED ACCOUNTING METHODS FOR COMPUTING THEIR ACCRUAL AND DEDUCTION OF RECLAMATION AND RESURFACING COSTS. BY CODIFYING THESE METHODS WE SHOULD CERTAINLY SETTLE ONCE AND FOR ALL THE MORE THAN 30 YEAR OLD CONTROVERSY BETWEEN THE SURFACE MINING INDUSTRY AND THE INTERNAL REVENUE SERVICE.

MR. CHAIRMAN, I URGE THIS COMMITTEE TO ACT FAVORABLY AND PROMPTLY DURING THE REMAINING DAYS OF THIS LAME-DUCK SESSION OF CONGRESS ON S. 2642.

Senator WALLOP. Good morning, all. The purpose of our hearing this morning is to receive testimony on two bills concerning the timing of tax deductions for mining reclamation expenses. The first bill is 1911. It was introduced by my colleague, Senator Specter, with companion legislation being introduced by Congressman Baily in the House. We will be hearing from both Senator Specter and Congressman Bailey. And I would like to take this opportunity to both recognize and commend their efforts in this area.

The second bill, S. 2642, was introduced by Senator Symms and myself in June of this year. That legislation is essentially identical to that offered by Senator Specter, with the exception that it also includes a codification of what is known as the "as disturbed" method of accruing mining reclamation expenses. Historically, the mining industry has relied on court cases from both the third and fourth circuits in determining how to accrue the estimated expenses of reclamation. That determination was that a surface mining operator should accure the estimated expenses of reclamation as the mining operations progressed. In 1978, some 20 years after those decisions, the Treasury Department issued a private letter ruling which departed from those earlier cases. Needless to say—I think it is obvious—that ruling was not openly embraced by the mining industry and brought on further litigation.

A recent decision in what is known as the *Ohio River Collieries* case reestablished the earlier precedent with a finding that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed, and thereby upholding the as disturbed method of accruing reclamation expenses.

The legislation we are considering today would codify that decision. It is clear from the Surface Mining Control and Reclamation Act of 1977, as well as legislation passed in many States, that there is a clear obligation for surface mining operators to reclaim the land they disturbed during the mining process. Indeed, mining operators must guarantee that they will comply with those reclamation laws by posting bonds with the State to cover the cost of reclaiming the land.

The real core of what is at issue here today stems from the regulations which accompany section 461 in the Tax Code. That regulation states that—

> An expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

It is the contention of the mining industry that those conditions are met during the course of the mining process rather than when those expenses may be actually incurred. Their position appears to carry with it the weight of judicial decisions on the subject. It is my understanding that the Treasury Department may have other concerns which go beyond the scope of this hearing, but which, on the basis of the precedential value of this legislation may have significant ramifications in other areas of tax law. I look forward to those comments and the discussion of their merits by the mining industry representatives who will be appearing before the subcommittee here this morning.

The first witness is my colleague from Pennsylvania, Senator Specter, who I again congratulate for taking an initiative in this area.

STATEMENT OF HON. ARLEN SPECTER, U.S. SENATOR, STATE OF PENNSYLVANIA

Senator SPECTER. Thank you very much, Mr. Chairman. It's a pleasure to be before you on this matter which is of great importance to the Nation as a whole, and including very substantial mining interests which affect the great States of Wyoming and Pennsylvania, as I say, as well as many, many others. And I commend the chairman for convening these hearings on this very important matter.

Mr. Chairman, I have prepared a testimony which I would like to have submitted for the record.

Senator WALLOP. By all means; it will be in the record in its entirety.

Senator SPECTER. And I can summarize it most expeditiously.

The reasons for the legislation have really been outlined by you, Mr. Chairman, very succinctly in your opening statement. There is a clear precedent for the deductibility of these expenses because the two criteria are satisfied of the legal requirement. And that is of a clear-cut obligation to undertake reclamation of the minesite, and the amount of the reclamation could be reasonably estimated or ascertained.

The decisions of the Court of Appeals for the Third Circuit and the Court of Appeals for the Fourth Circuit have established these principles as in the more recent case of *Ohio River Collieries* v. *Commissioner*. I am, frankly, at a loss to understand the Internal Revenue Service's position, but these differences do arise from time to time when the Service concludes that in the absence of a decision by the Supreme Court of the United States it can continue to litigate the matter with some hope of establishing a different rule perhaps in one of the other circuits, and having a conflict in the off chance—and it is a very slight chance given the cert policy of the Supreme Court to have it reviewed.

But if the Congress were to act on this matter then it would be concluded and it would be a very important matter for the mining interest.

With respect to the issue of coal mining, it is unnecessary at this juncture in our Nation's history to underscore the importance of stimulating the mining of coal as an alternative source of energy to OPEC oil. From the environmental point of view, again, it is unnecessary to elaborate upon the benefits for the land to have these minesites put back into proper condition so that the natural beauty may be restored. I've had occasion to visit minesites all over the State. Most recently, in Pittston, Pa., where the issue arose as to certain funds, which had been appropriated and had been set aside, and through a lot of strenuous efforts which are really collateral for this issue, those funds were reinstated and the minesite was put back into a decent condition. But the environmental interest certainly requires that the miners be able to make these deductions so that these funds can be available for that very important purpose.

As the chairman has initially done so, I acknowledge the work of Congressman Bailey, my colleague from Pennsylvania, who took the lead on this matter before I came to the Senate, and had introduced legislation on this subject. And I was pleased to cooperate with him by introducing the legislation on the Senate side in the form of S. 1911. And then I was very pleased to see you, Mr. Chairman, along with our colleague Senator Symms, who is with you on this hearing, having introduced S. 2642. And I think either of these bills would accomplish the purpose that we are looking for. And I would very much like to see this matter reach fruition at an early date. It is obviously not going to be a matter taken up in the lameduck. One of the great problems is everywhere you go you hear people say the lameduck is going to accomplish something or other, which it can't possibly. But if this does not take the form of a separate tax bill, perhaps we can find a vehicle early next year to add it on as an amendment where it can get the proper attention and proper expeditious action.

Senator WALLOP. Thank you, Senator Specter.

[The prepared statement of Senator Specter follows:]

TESTIMONY BY ARLEN SPECTER
DECEMBER 7, 1982
10:00 A.M.

BEFORE THE SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION OF THE
SENATE JOINT COMMITTEE

Mr. Chairman, on December 4 of last year Senator Robert Byrd and I introduced S. 1911, a bill to amend the Internal Revenue Code of 1954 to provide for the establishment of reserves for mining land reclamation and for the deduction of amounts added to such reserves.

The necessity for this legislation results from the position of the Internal Revenue Service that it will not follow longstanding appellate court cases which permitted taxpayers to deduct the estimated costs of governmentally mandated reclamation expenses as the obligations are incurred. In the 1950's, both the Third and Fourth Circuit Courts of Appeal concluded that deductions for accrued reclamation expenses were allowable under existing tax law. These decisions held that reclamation expenses could be accrued if two criteria were satisfied: The fact of an obligation to undertake reclamation of the mine site had occurred and the amount of the reclamation expenses could be reasonably estimated.

The IRS has not followed those decisions. As a result, audit controversies and litigation have arisen over the tax treatment of accrued reclamation expenses. The intent of S. 1911 is to clarify existing law.

S. 1911 was intended to help resolve these controversies by making it clear that accrued reclamation expenses attributable to surface mining are deductible if reclamation is required by

the "Surface Mining Reclamation and Control Act of 1977" or other applicable State or Federal law. This treatment is entirely consistent with proper accrual method accounting rules for accrual basis taxpayers.

By prescribing appropriate treatment of accruals, the tax savings would assist companies in financially satisfying their obligations to undertake environmentally sound reclamation projects. Further, the legislation would benefit companies engaged in the extraction of coal, our most abundant source of domestic energy, and thereby have a potentially favorable impact in attaining our national energy goals. Moreover, S. 1911 would address the basic inequity of mandating by law the expenditure of substantial sums of money for reclamation without clearly recognizing the obligation imposed for income tax purposes. It does not seem reasonable for the Federal Government on the one hand to impose a reclamation obligation to achieve desirable environmental goals but, on the other hand, to deny the existence of the obligation for purposes of its income tax laws.

When I introduced S. 1911 a year ago, I noted that under the bill the deduction for accrued reclamation expenditures can be recovered on a ratable method over the life of the mine. However, I noted that an argument has been made that reclamation expenditures, once reasonably determined, should be accrued and deducted at the time the ground is disturbed, since it is the act of disturbance which caused the obligation to be imposed. I noted then that I reserved judgment on this issue.

Since the introduction of S. 1911 the U.S. Tax Court in Ohio River Collieries Co. v. Comm. has adopted a slightly different rule than that provided in the earlier Circuit Court decisions and you, Mr. Chairman have introduced S. 2642 to reflect this most recent decision.

I can, under the legal situation which exists today, endorse either S. 1911 or S. 2642. In any event it is our intention in these bills only to codify the 1950 decisions made by the U.S. Circuit Courts and, now, by the U.S. Tax Court, as well.

I must not conclude without noting the pioneering work in this Congress on this issue by Congressman Bailey who introduced H.R. 4815 on October 22, 1981, prior to the introduction of Senate legislation on this subject.

Thank you Mr. Chairman.

Senator WALLOP. I would say one thing. There is, as required, an estimate of the revenue effects of this bill which is $15 million in the first year and 6, 5, 5, and 5 for the outyears so I have a difficult time understanding how there can be a revenue effect when what you are doing is codifying existing law. It seems to me rather the revenue effect would be the reverse if we were to repeal. It might be a positive one, but there can't be a negative one because we are doing what is already being done by court decisions.

Senator SPECTER. Mr. Chairman, I think that's conclusively correct. It may be the Commissioner's view to the contrary, but it's not the law. The law is that which has been expressed by the courts, the third and fourth circuits, and the Tax Court in *Collieries.*

Senator WALLOP. I wish to thank you for coming here this morning. We appreciate your efforts in this thing, and maybe we will find something that will work.

Senator SPECTER. Thank you very much, Mr. Chairman.

Senator WALLOP. Mr. Symms has a statement.

Senator SYMMS. Thank you very much, Mr. Chairman. I would like to compliment you, Mr. Chairman, for holding the hearing, and express my support for it. And thank you, Senator Specter, for your interest in the matter.

This may be something that seems somewhat trivial to some people, but it's a very important issue to the American mining industry. And I want to compliment you. I see Congressman Bailey is here—and thank him for his efforts. I think it is very important that we move ahead with this. And I think now that we have had the hearings or when this morning's are completed, we should be able to find some vehicle to tie this onto either this year or next year and get the matter tended to. I want to thank you both.

I would like to advise and extend my remarks, and apologize to you, Mr. Chairman, but the Highway bill is now being marked up in the Environment Public Works Committee which is going to require my attention so I am going to have to ask your forgiveness to depart.

Senator WALLOP. Not at all. We appreciate it.

[The prepared statement of Senator Symms follows:]

COMMITTEE ON FINANCE, SUBCOMMITTEE ON AGRICULTURE AND ENERGY TAXATION
SENATOR STEVE SYMMS, DECEMBER 7, 1982

Good morning. I would like to compliment and thank my colleague from Wyoming, Senator Wallop, for holding this hearing today, and express my gratitude to both Senator Spector and Senator Wallop for their continuing interest in a matter, which might seem trivial, but which is of great importance to the American mining industry.

I regret that I will not be able to remain here for the entire hearing because of my obligations in the Environment and Public Works Committee, but I do want to assure all interested parties that I strongly support the early passage of Senator Wallop's bill, S. 2642, with a minor, technical amendment attached to it.

This legislation addresses the current deductibility of future mine reclamation expenses and eliminates the areas of controversy by providing that taxpayers will be allowed a current deduction for specified future reclamation expenses under either of two options, both of which reflect accrual methods the courts have found acceptable. First, a taxpayer could currently deduct the amount of its estimated future reclamation expenses which were allocable to the minerals mined during the current taxable year. Second, under another alternative, a taxpayer would be allowed to currently deduct the estimated expenses for reclamation of that part of the mineral property which was disturbed by surface mining activity in the current year.

Either of these alternatives results in a clearer reflection of a mine operator's income than is the case under the position

maintained by the Revenue Service which requires a mine operator to wait to deduct the expenses of reclaiming a mine until it has completed its mining activities on that property, and accordingly, has realized its income with respect to that mine. The effect of the I.R.S. position requires the taxpayer to currently realize income from the mining activity on the mine, but wait until the mine is closed to deduct an expense that legally results from the same mining activity, specifically, the expense of reclaiming property.

Insofar as the technical amendment which I believe needs to be attached to the bill, I believe that an inadvertent oversight was made when this bill was drafted. S. 2642 should be amendment so it is also applicable to surface reclamation required by law as a result of underground mining.

In addition, I would like to stress that Committee report language should include language specifying that a taxpayer's estimate of future reclamation expenses will be considered to meet the reasonable accuracy test, if the estimate is formulated in accordance with generally accepted mining engineering practices or generally accepted accounting principles or is formulated by an independent mining engineering firm. Clarifying this point in the Committee report language would significantly narrow any future controversy with the Internal Revenue Service regarding the proper time for deducting mine reclamation expenses.

I believe that it is extremely important that we settle this issue as soon as possible. There have been major changes in both the federal and state level in the legal framework governing mine reclamation. The requirements and standards imposed on mine owners with respect to their liability to reclaim land have been substantially strengthened and broadened. In addition, the energy shortages in

recent years have resulted in more surface coal mining operations in order to meet our country's energy needs. Also, we should be encouraging the domestic production of strategic minerals domestically so as to reduce our dependence on foreign sources for these vital mineral resources necessary to the economy and defense of our country.

Furthermore, the mining industry is in a state of depression. Any attempts to unlawfully restrict their cash flow, such as the Internal Revenue Service's incorrect implementation of present law, directly impacts on the continued ability of this country to produce minerals that fuel our economy. The efforts by the I.R.S. to cripple this basic industry should not be acceptable to responsible legislators.

STATEMENT OF HON. DON BAILEY, U.S. REPRESENTATIVE, STATE OF PENNSYLVANIA

Senator WALLOP. And we welcome Congressman Bailey.

Congressman BAILEY. Thank you.

Senator WALLOP. Morning, Congressman.

Congressman BAILEY. Morning, morning.

Thank you Senator. If I cut into your time somewhat, I have a copy here that I can submit for the record. I do address some of the more technical issues so naturally please feel free to cut off a garrulous congressman, Senator, anytime you please.

I want to begin by complimenting you and the subcommittee. And particularly Senator Specter who has been so helpful. We have worked together on this. We looked at this issue originally together, and he has been instrumental in keeping the issue alive. And I want to put that on the record to his benefit.

Chairman Wallop, and members of the subcommittee, I want to thank you, Mr. Chairman, for giving me the opportunity to testify this morning before this subcommittee on an issue that is of great importance not only to the surface mining industry, but to our country as well. The scheduling of this hearing is the first step to addressing the tax accrual of reclamation cost problems for the industry, as well as the energy needs of our country. And I'd like to commend you and the other members of the subcommittee for providing this forum.

As a member of the House Ways and Means Committee and a member concerned about our Nation's energy dilemma, I, too, have long been interested in this tax issue. My interest and concern culminated in my introducing the Mining Reclamation Reserve Act of 1981, H.R. 4815, which my colleague, Senator Arlen Specter, later introduced as S. 1911.

The intent of H.R. 4815, S. 1911, and the chairman's bill, S. 2642, is to clarify existing tax law and to eliminate any question that an accrual basis taxpayer is entitled to take current deductions for estimated future reclamation expenses when complying with the surface mining reclamation requirements of both State and Federal law. Current case law under the Internal Revenue Code and technical IRS rulings highlight the contradictions and ambiguities concerning the right of surface mining operators on this point.

Under the accrual method of accounting, an expense deduction generally cannot be taken until all the events occur which determine the fact of the liability and the amount of the expense can be determined with reasonable accuracy. For surface mining operators, the liability exists as a consequence of the reclamation requirements imposed by the Surface Mining Control and Reclamation Act of 1977 and many State-enacted reclamation laws. When a surface mining permit application is made, a reclamation plan is included and reviewed by a State regulatory body or the Federal Office of Surface Mining. This reclamation plan must be approved before an operator permit is issued. Both the requirement and the plan are sufficiently detailed to demonstrate the existence of a future obligation once the strip mining begins, and thus an expense liability eligible for deduction under generally applicable tax rules. For a taxpayer using the cash method of accounting, these reclamation expenses may be deducted when paid. For accrual method taxpayers, however, the law is unclear as to when they can deduct the expenses. In H.R. 4815, S. 1911, and S. 2642, expenses in the form of additions to a reserve may be deducted in the year in which all events have occurred which determine the fact of liability and the amount is determinable with reasonable accuracy. H.R. 4815 and S. 1911 require accrual method taxpayers to allocate reclamation expenses to the minerals extracted. S. 2642, on the other hand, would allow eligible deductions to be taken in the year in which the land is disturbed.

Unfortunately, the IRS has issued technical rulings disallowing what should be eligible deductions. Their position, as conveyed most recently in Assistant Secretary of the Treasury John Chapoton's letter to me of May 20, 1982, is that "an accrual-basis taxpayer cannot deduct an expense for performing a service prior to the time the service is performed, primarily because until such time the taxpayer has merely agreed to become liable in the event the future services are performed."

Standing alone, the argument is certainly plausible and easily defended. I believe, however, that this position is at variance with the Federal reclamation requirements imposed on surface mining operators as a condition of doing business. What the IRS has called a stage of agreeing to become liable is, in reality for our taxpayers, a time of incurring actual expenses and responding to legal and financial obligations. These obligations and requirements, particularly the requirement that operators post a surety bond to insure reclamation, have been found to satisfy the "all the events test" of the Internal Revenue Code regulations determining the eligibility of accrual deductions. As held in the U.S. Tax Court decision of *Ohio River Collieries Co.* v. *Commissioner,* a reclamation law requiring the estimation of reclamation costs and the posting of a surety

bond, as in Ohio, insures that reclamation will occur following the intended strip mining. The reclamation is a certainty once strip mining begins, not an event of some doubt. And, as such, a liability is incurred when an operator meets the reclamation requirements, is issued a permit, and commences strip mining.

The Tax Court's decision in *Ohio River Collieries Co.* v. *Commissioner* generally follows the line of argument behind H.R. 4815, S. 1911, and your bill, Senator, 2642. Like the court, these bills have addressed the question of what constitutes a qualified reclamation plan and a reasonably accurate estimate of expenses by focusing on the requirements of the Surface Mining Control and Reclamation Act or State requirements that are substantially similar. In many States, of course, more stringent reclamation requirements are imposed on operators.

Naturally, however, the three bills provide that no qualified plan may be any less stringent than Federal reclamation law. The reason is simple—to conform to the dictates of Federal environmental law.

With respect to the reasonable accuracy of estimated expenses, I believe that the requirements of the reclamation plan itself include factors that bear on the accuracy and reasonableness of the estimated expenses. In the *Ohio River* case, both parties stipulated that the expenses were reasonably estimated. I think that's an important point. Both parties stipulated that the expenses were reasonably estimated. Now this suggests to me that State officials, the IRS, and operators would not quarrel with our view that reclamation plans contain sufficiently detailed information for estimating the extent of future reclamation costs and thus the extent of the liability incurred. However, in H.R. 4815, the Secretary of the Treasury is not precluded from challenging the accuracy of estimated expenses, nor does the bill require mine operators to obtain the advanced approval of the Secretary of the estimated expenses in their reclamation plans.

The chairman's bill and my bill are identical on this point as well as in allowing taxpayers to elect accrual or reserve accounting on a property-by-property basis. This flexibility is, I believe, an important provision that should be retained. I'm sure IRS is going to have some comments on that point, Senator.

Because of the variability in time and amount of reclamation expenses across different surface mining operations, a company should have maximum flexibility to elect reserve accounting on a property-by-property basis. This provision is also consistent with the present administration's desire to increase production by allowing businessmen the most efficient methods of getting the job done.

H.R. 4815 and S. 1911 would also require estimated expenses to be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted ratably over the life of the surface mining operation. Since our objective is to allow companies to match their reclamation expenses with the flow of income from the sale of extracted minerals, this provision may not only be the easiest to account for, but also meets the basic requirements of fairness. In short, we enhance the cash flow position of the companies involved and thus provide for a fairer and more efficient utilization of their investment resources.

The chairman's bill and my bill are also the same in providing transition rules and safeguards in the event of excessive reserve amounts. Estimated reclamation expenses which have not been deducted prior to the first taxable year for which reserve accounting has been elected are treated as deferred expenses and may be deducted ratably over a 60-month period. If the mining is completed in less than 60 months, then the expense can be deducted ratably over that shorter period. Excessive reserve amounts are treated as taxable income in the year in which the excess occurred. This is only fair.

The problem these bills address, Mr. Chairman, is a very serious one for the surface mining industry. The mismatching of income and deductible expenses has not only led to a severe accounting problem, but also to less than optimal production decisions. This only exacerbates our Nation's energy dilemma. At minimum, the IRS should be required to follow the *Ohio River* case. In addition, as provided in H.R. 4815, cash method surface mining operators should be allowed to elect accrual accounting of their reclamation costs on a property-by-property basis and to be able to deduct their reclamation reserves from income from the sale of extracted minerals. The fact of reclamation expense liability is a condition of surface mining in the country. Reclamation is no longer a future event of some doubt. The IRS position with respect to accrued reclamation expenses needs to be changed and these bills provide the fairest and most reasonable approach as to when and how these deductions should be taken.

Mr. Chairman, I, again, want to thank you very much. I would like to say that if we are successful in doing something with this, I think I would rather see your bill. But, if not, some of the standards that we have written into Senator Specter's bill and my bill I would hope we could reach.

And I want to personally thank you for persisting with this. If you hadn't, I couldn't have done anything on my side. And I think proper public attention should be called to the fact that it's your effort that has kept this thing alive and in front. And I am grateful to you.

Senator WALLOP. I appreciate your remarks. And I think you made a couple of good points. Without being argumentative, Buck's letter to you—the fact is that they have not merely agreed. It is an obligation which is not deductible. The bond will pick it up if they don't. I mean in one way or the other that expense will be met.

I think another point that you made is particularly apt in these periods of slack production and slack demand for the product. And that is it allows a company to match its reclamation expense with its flow of capital and with its activities in the mine. There are a lot of people who are not able to produce in full measure right now, a whole lot of them. Again, I question the revenue figures for the simple reason that you cannot have a loss of expectation if you are going to have a loss of reality. And the reality is that we are trying to codify what is law by court decision now. It may take some of a future expected gain by a change in law, but that's not in the world of business a reality until it occurs.

Congressman BAILEY. I think one has to wonder sometime, Senator, and I do myself. I sit down and look at the tax law we write,

and I very much wish that sometimes when we talk about the impact of regulation, its affect on productivity, and what we would view as an investment factor. I think that when we look at what you and I are trying to accomplish here, and Senator Specter is trying to accomplish here, I think in the long run we can honestly say it will pay dividends far in excess of what minor revenue loss may initially occur or perhaps what inconveniences may be met in accounting problems for IRS initially. We need to give these people flexibility. We need to provide every possible dollar for investment purposes as soon as possible. And there's an elementary element of justice and fairness involved here, too, which, of course, you have commented on. I think we can honestly say from a multifaceted point of view that this is only fair, right, and to the benefit of our country.

Senator WALLOP. For the moment at least, it's still law. We would just like to have it statutory law instead of decision law.

I appreciate you coming over this morning. Thank you.

Congressman BAILEY. Thank you, Senator.

Just one more thing. Just two more people I wanted to thank on the record. A staff member that has worked very hard with us and that's Mr. Clint Stretch, a member of the Joint Tax Committee staff. And Mr. David Flanders, a staff member of mine who has done an outstanding job in working with me and getting information for me. And when Buck comes in, if you would tell him I said hello, I would appreciate it.

Senator WALLOP. You can do it yourself. He's right behind you.

Congressman BAILEY. Buck, how are you? We laid a little groundwork for you.

[The prepared statement of Congressman Don Bailey follows:]

STATEMENT OF HON. DON BAILEY BEFORE THE SENATE FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURE TAXATION, DECEMBER 7, 1982

Chairman Wallop, and Members of the Subcommittee:

I want to thank you, Mr. Chairman, for giving me the opportunity to testify this morning before this Subcommittee on an issue that is of great importance not only to the surface mining industry, but to our Country as well. The scheduling of this hearing is a first step to addressing the tax-accrual of reclamation cost problem for the industry as well as the energy needs of our Country and I'd like to commend you and the other Members of the Subcommittee for providing this forum.

As a Member of the House Ways and Means Committee and a Member concerned about our Nation's energy dilemma, I, too, have long been interested in this tax issue. My interest and concern culminated in my introducing the Mining Reclamation Reserve Act of 1981, H.R. 4815, which my colleague, Senator Arlen Specter, later introduced as S. 1911.

The intent of H.R. 4815, S. 1911, and the Chairman's bill, S. 2642, is to clarify existing tax law and to eliminate any question that an accrual-basis taxpayer is entitled to take current deductions for estimated future reclamation expenses when complying with the surface mining reclamation requirements of both state and federal law. Current case law under the Internal Revenue Code and technical Internal Revenue Service rulings highlight the contradictions and ambiguities concerning the right of surface mining operators on this point.

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In H.R. 4815, S. 1911, and S. 2642, expenses in the form of additions to a reserve may be deducted in the year in which all events have occurred which determine the fact of liability and the amount is determinable with reasonable accuracy. H.R. 4815 and S. 1911 requires accrual-method taxpayers to allocate reclamation expenses to the minerals extracted. S. 2642, on the other hand, would allow eligible deductions to be taken in the year in which the land is disturbed.

Unfortunately, the IRS has issued technical rulings disallowing what should be eligible deductions. Their position, as conveyed most recently in Assistant Secretary of the Treasury John Chapoton's letter to me of May 20, 1982, is that "an accrual-basis taxpayer cannot deduct an expense for performing a service prior to the time the service is performed, primarily because until such time the taxpayer has merely agreed to become liable in the event the future services are performed."

Standing alone, this argument is certainly plausible and easily defended. I believe, however, that this position is at variance with the federal reclamation requirements imposed on surface mining operators as a condition of doing business. What the IRS has called a stage of agreeing to become liable is, in reality for our taxpayers, a time of incurring actual expenses and responding to legal and financial obligations. These obligations and requirements, particularly the requirement that operators post a surety bond to insure reclamation, have been found to satisfy the "all the events test" of the Internal Revenue Code regulations determining the eligibility of accrual deductions. As held in the U.S. Tax Court decision of Ohio River Collieries Co. v. Commissioner, a reclamation law requiring the estimation of reclamation costs and the posting of a surety bond, as in Ohio, insures that reclamation will occur following the intended strip mining. The reclamation is a certainty once strip mining begins, not an event of some doubt. And, as such, a liability is incurred when an operator meets the reclamation requirements, is issued a permit, and commences strip mining.

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Naturally, however, the three bills provide that no qualified plan may be any less stringent than federal reclamation law. The reason is simple - to conform to the dictates of federal environmental law.

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The Chairman's bill and my bill are identical on this point as well as in allowing taxpayers to elect accrual or reserve accounting on a property-by-property basis. This flexibility is, I believe, an important provision that should be retained. Because of the variability in time and amount of reclamation expenses across difference surface mining operations, a company should have maximum flexibility to elect reserve accounting on a property-by-property basis. This provision is also consistent with the present Administration's desire to increase production by allowing businessmen the most efficient methods of getting the job done.

H.R. 4815 and S. 1911 would also require estimated expenses to be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted ratably over the life of the surface mining operation. Since our objective is to allow companies to match their reclamation expenses with the flow of income from the sale of extracted minerals, this provision may not only by the easiest to account for, but also meets the basic requirements of fairness. In short, we enhance the cash-flow position of the companies involved and thus provide for a fairer and more efficient utilization of their investment resources.

The Chairman's bill and my bill are also the same in providing transition rules and safequards in the event of excessive reserve amounts. Estimated reclamation expenses which have not been deducted prior to the first taxable year for which reserve accounting has been elected are treated as deferred

expenses and may be deducted ratably over a 60-month period. If the mining will be completed in less than 60 months, then the expense can be deducted ratably over that shorter period. Excessive reserve amounts are treated as taxable income in the year in which the excess occurred. This is only fair.

The problem these bills address, Mr. Chairman, is a very serious one for the surface mining industry. The mismatching of income and deductible expenses has not only led to a severe accounting problem, but also to less-than-optimal production decisions. This only exacerbates our Nation's energy dilemma. At minimum, the IRS should be required to follow the Ohio River Collieries case. In addition, as provided in H.R. 4815, cash-method surface mining operators should be allowed to elect accrual accounting of their reclamation costs on a property-by-property basis and to be able to deduct their reclamation reserves from income for the sale of extracted minerals. The fact of reclamation expense liability is a condition of surface mining in the Country. Reclamation is no longer a future event of some doubt. The IRS position with respect to accrued reclamation expenses needs to be changed and these bills provide the fairest and most reasonable approach as to when and how these deductions should be taken.

Again, Mr. Chairman, I appreciate your giving me the opportunity to testify before the Members of your Subcommittee this morning on this important issue. I hope my comments will help you and your colleagues as you consider the provisions of the measures before you.

STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Senator WALLOP. Good morning, Buck. Welcome to the committee.

Mr. CHAPOTON. Good morning, Mr. Chairman. I appreciate the opportunity to present the Department's views on this matter. It is a very significant matter. We recognize the significance of it to the mining industry. As we state in our written statement, it's a very significant question in our tax law in general.

I can be fairly brief. We know what the bills would provide. We know that they would settle a controversy that has been pending between the mining industry and the IRS in favor of the industry. The industry, of course, has taken the position that the estimated amount of reclamation expenses should be deductible. When statutory obligations arise the reclamation work may be deducted.

IRS has taken the position that it's deductible only when the taxpayer incurs a present liability to pay for the reclamation work. And the Tax Court, of course, in the *Ohio River* case—has recently held for the taxpayer. And these bills would codify the Tax Court's decision for accrual method taxpayers and would go further and provide that same treatment for cash basis taxpayers.

The first point I would like to make is that this problem is not unique to the mining industry, even though it probably shows up in greater relief at the present with respect to the mining industry. But I think we must recognize that taxpayers often generate income in one year and incur an expense directly associated with that income in a subsequent year.

I will also state that there is a good deal of appeal, at least at first glance, to the taxpayers' claims that they should be entitled to the current deduction of the future expenses. True profit from any income producing activity can only be determined by taking related expenses into account. That's an obvious statement, and it's true here as well as in other circumstances.

We are opposing these bills on three broad consideration grounds. First, and this is a point that we make at some length in the written statement, a rule that grants a deduction today for an expense that will be incurred tomorrow overstates the true cost of the expense to the extent that the rule fails to take into account the time value of money.

Second, we point out that the rule is difficult to administer since estimates of the future expenses are inherently uncertain.

And then, third, we point out the revenue impact to such a rule, if it were applied evenhandedly to all similarly situated taxpayers—and I suggest that—whether it would happen today or later, it would certainly happen before too many years.

As to the problems of overstating the true cost of the expense, we have got a rather lengthy attachment to the statement that goes into that. But it's basically that the expense—the example we use is a liability or an obligation to pay an expense 7 years in the future of $100, for example, is certainly not equal to $100 today. And, therefore, you misstate the deduction if you give a deduction for $100 today for an expense that is incurred later. You misstate it by the time value of the money.

We go on to point out that delaying the deduction of $100 to year 7, in fact, accurately allows the expense. And we can discuss that a minute if you like. But if you assume that the value of the money will grow over time the after tax increase in the value of the money set aside for the future expense, then——

Senator WALLOP. That's to say that's the experience of the last decade. The value of the money does not grow over time.

Mr. CHAPOTON. Well, of course, the cost of the obligation diminishes in the same proportion. What it seems must really happen in a true economic sense is that the buyer of the coal will pay something for the coal, and the seller of the coal will sell the coal for a price, and he will also charge something for the present value of his future obligation due to reclamation work. And he pays tax currently on that dollar he receives for the latter item. And so he has overstated his tax in the year he receives that first amount, but then he gets the remaining dollars that he received for that future obligation, because I am sure he is not in the business for the fun of it, and that amount will grow sufficiently to meet that obligation in the future. Or he has misjudged the economics of the situation.

Senator WALLOP. You can challenge that, but, are we as a country in the habit of taxing the time value of money?

Mr. CHAPOTON. No. Well——

Senator WALLOP. That's a pretty bizarre concept in some cases.

Mr. CHAPOTON. I'm not saying we are taxing the time value money or not taxing it. I'm saying that if I have an obligation to pay something—let's say $100 obligation 7 years in the future, clearly, that obligation does not equal a $100 deduction right now. And if you are going to reimburse me for that expense, you don't reimburse me for $100 so we misstate the deduction if we give me a full $100 deduction at this time.

Senator WALLOP. By the same token, then, other income would be affected at that period down the road—7 years hence.

Mr. CHAPOTON. Well, the deduction would be in dollars when the outlay is made, and I suggest even though it is an analysis that does require some thinking about and some computation that does reach the correct result. We have given this a good deal of thought. I think it's something I would like to hear the industry respond to.

But what we are suggesting is mathematically and economically—you reach the correct result even though I can see immediately at first glance it doesn't appear that you do so.

One point we do make, though, is that for this to work correctly—the deduction of the work at the back end, 7 years hence—there has to be income against which to take the deduction. And if there is not, if that deduction has to be carried forward, then it does not work perfectly. And what we suggest is if that is a problem then perhaps an extended carryback to make sure that when expenditure is made or the liability for the payment is incurred that a deduction is available. That is a deduction against income is necessary back to the time the original income is earned. Otherwise, there is a permanent penalty involved. And then just a couple of other points. The precedent that we cannot overlook is the enactment with the 1954 code of section 462 which did allow an accrual of estimated future expenses under the same type of argument that we are seeing now. And that, as we recognize, has some

appeal. But that provision—section 462—was repealed retroactively in 1955, 1 year later because of the administrative difficulty and because of the concern about the revenue loss. I'm afraid we have to be careful that we don't reenact section 462. And, indeed, the Tax Court in the *Ohio River* case was very careful to avoid the charge that it was, in effect, reenacting section 462.

There are, though, many other taxpayers who could make similar claims. Some we have mentioned in the testimony. The estimated amount of workers' compensation costs, product liability and warranty claims, unfunded pension liabilities, the cost of dismantling off-shore drilling rigs and a very similar cost of decommissioning nuclear powerplants in the future.

We do think, Mr. Chairman, that the *Ohio River* case was incorrectly decided even though the court—once the question of the reasonableness of the estimate was stipulated by the Government and the taxpayers, it made it a lot easier for the court to reach the decisions that it did reach. The revenue estimates that you pointed to would assume that the Government's position would eventually prevail because, as we state, we have not conceded the issue. And also the court in its own opinion went to great lengths to state—they state:

> We deem it necessary to stress that the potential for abuse makes it essential that the all events test of the regulation continue to be strictly construed in future cases of this nature before the court. And that such cases are not viewed as occasions to judicially reenact the section 462 that the Congress repealed in 1955.

So even with that case standing in the law, it does not cover every case that arises. These bills would cover cash basis taxpayers as well as accrual basis taxpayers and would wipe the slate clean so those arguments would no longer exist.

Senator WALLOP. Is the *Ohio River* case under appeal?

Mr. CHAPOTON. The *Ohio River* case is not under appeal. No, sir.

Senator WALLOP. Well, I can see some of the problems that you are talking about. For example, the cost of decommissioning a nuclear powerplant. But those are different to the extent that they are not required as a condition of doing business in the first place. Certainly, with regard to workmen's compensation, unfunded liability, those are estimates that are really arguable. But certainly on the other side these estimates of reclamation are rather more specific. I mean they require a great deal of detailed engineering in the permit process and the application process.

Mr. CHAPOTON. I understand that. I think the decommissioning is quite close even though I do not have at hand all the facts. I understand that there is a requirement at the front end that the ability to decommission be shown. And I think that case would be quite close. The other cases, I agree, are not quite as close because you do get into estimated expense. The point is, though, that they do involve the question of a mismatching of expenses. That is, income earned now and expense as related to that income being incurred later.

Senator WALLOP. If we were to allow a deduction on the basis of the present value of that deduction, is there any way that Treasury could recommend a procedure for estimating the discount percentage?

Mr. CHAPOTON. You would have to be arbitrary, I would assume, because the correct percentage would be what the company would earn on the additional amount it receives for this future expense. And it would be, in effect, its internal rate of return. I would hope, though, that—our review of it shows, if you read our testimony; particularly, the appendix of the testimony closely, that without an acceleration of the deduction even at a discounted basis we reach that result when the later deduction is allowed provided that there is income against which to take that later deduction. And a longer carryback could well be necessary to reach that result.

Senator WALLOP. Would there be a recommendation as to how far back that could be carried? Would it be for the life of the project and the income of it?

Mr. CHAPOTON. I think we would not have any significant problem with extended carryback.

Senator WALLOP. How would we then estimate the time value of money to the Treasury?

Mr. CHAPOTON. Then you would have the things in sync. The time loss to the Treasury and the cost to the taxpayer occur in the year when the expense is incurred.

Senator WALLOP. Maybe. It seems a concept that would clearly run both directions, at least that arguably run in both directions.

I haven't had a chance to review your whole commentary. And I believe as Congressman Bailey pointed out, this is not a runaway train at the moment with the lameduck session. But I look forward to doing it and discussing further with you how we might accomplish this. At least the courts seem to think that is one appropriate direction.

Mr. CHAPOTON. Yes; we have noticed that.

Senator WALLOP. Thank you very much.

Mr. CHAPOTON. Thank you.

[The prepared statement of John E. Chapoton follows:]

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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1911 and S. 2642, which would permit both cash and accrual method taxpayers to deduct the estimated cost of surface mining reclamation work in a taxable year prior to the year such work is performed. For reasons that I will discuss, Treasury is strongly opposed to both of these bills.

Background

The Surface Mining Control and Reclamation Act of 1977 and similar state laws require surface mine operators to restore land that is damaged by the mining process. In many cases the mine operator either must post a bond to insure his future performance of the required reclamation work or otherwise must demonstrate financial capability to perform the required reclamation work after mining activities are completed.

S. 1911 and S. 2642 are an outgrowth of a controversy which has existed for some time between mine operators and the Internal Revenue Service over the proper time to accrue deductions for the cost of statutorily mandated reclamation work to be performed in the future. The Service takes the position that such expenses are not accruable until the taxpayer incurs a present liability to pay for the reclamation work. Taxpayers argue that the estimated amount of the reclamation expenses should be deductible when the statutory obligation to perform the reclamation work arises.

In a recent decision, the Tax Court held that the estimated expenses of an accrual method taxpayer to be incurred in future taxable years to satisfy its statutory obligation to reclaim strip-mined land were accruable during the year of the mining operation, even though reclamation work had not been started and the taxpayer had no present liability to pay for the performance of such work. Ohio River Collieries Co. v. Commissioner, 77 T.C. 1369 (1981). S. 1911 and S. 2642 would codify the Tax Court's decision on this issue for accrual method taxpayers and would provide similar treatment for cash method taxpayers.

Description of S. 1911 and S. 2642

S. 1911 and S. 2642 would permit both cash method and accrual method taxpayers, in computing taxable income for any year, to elect to deduct a reasonable addition to any reserve established for the estimated expenses of surface mining land reclamation. The election would be made on a property by-property basis. For this purpose the term "property" has the same meaning as in section 614 of the Code; that is, each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land is treated as a separate property. The estimated expenses would be allocated to the minerals extracted. Thus, the accrued reclamation expenses would be deducted over the life of the mine as minerals are produced.

The primary difference between the two bills is that S. 2642 also would allow a taxpayer to elect to allocate estimated expenses to the property "disturbed" rather than to minerals extracted. This would mean that expenses could be deducted as the land is "disturbed." S. 2642 does not clarify what types of "disturbance" would give rise to the deduction.

The bills define the "estimated expenses of surface mining land reclamation" as those expenses otherwise deductible under the income tax law which are (1) attributable to "qualified reclamation activities" to be conducted in future years, (2) are subject to estimation with reasonable accuracy, and (3) are either allocable to minerals extracted before the end of the taxable year (or, in the case

of S. 2642, are allocable to that portion of the property disturbed in the taxable year). The term "qualified reclamation activities" is defined as land reclamation activities conducted under a reclamation plan submitted as part of a surface mining permit application under the Surface Mining Control and Reclamation Act of 1977 or under a plan submitted pursuant to a Federal or State law imposing substantially similar surface mining land reclamation requirements. If the amount in any reserve for estimated expenses of surface mining land reclamation is determined to be excessive at the close of any taxable year, then the excess shall be included in gross income in that year. Nonqualified land reclamation expenses of electing taxpayers would be deductible in accordance with regulations to be prescribed by the Secretary.

S. 1911 and S. 2642 also provide special treatment for estimated expenses of surface mining land reclamation that are attributable to mining activities occurring before the first taxable year for which the reserve accounting method is elected and that have not previously been deducted. These estimated expenses are treated as deferred expenses and may be deducted ratably over a 60-month period beginning with the first month of the first taxable year for which reserve accounting is elected. If mining of a property with respect to which there are deferred expenses will be completed in less than 60 months, then the expenses can be deducted ratably over that shorter period.

The bills generally would be effective for taxable years ending after the date of enactment. However, they also would validate retroactively the deduction of these estimated future expenses for accrual method taxpayers who have accrued such expenses for one or more taxable years ending on or before the date of enactment.

Discussion

S. 1911 and S. 2642 deal with a problem of income measurement that is not unique to the mining industry. Taxpayers often generate income in one year and incur an expense directly associated with generating that income in a subsequent year. Indeed, generally accepted accounting principles frequently require the establishment of reserves for such future expenses, thus reducing net profit as reported on financial statements.

At first glance, there is some appeal to taxpayers' claims that they should be entitled to current deductions for these future expenses. The true profit from any income-producing activity can only be determined by taking all related expenses into account. Nevertheless, there are three broad considerations that militate against permitting current deductions for future expenses. First, a rule that grants a

deduction today for tomorrow's expense overstates the true cost of the expense to the extent that the rule fails to take into account the time value of money. Second, such a rule is difficult to administer, since estimates of future expenses are inherently uncertain. Finally, the revenue loss from such a rule, applied evenhandedly to all similarly situated taxpayers, would be prohibitive.

The first of these problems -- the overstating of the true cost of the future expense outlay -- is best demonstrated by example. Assume the taxpayer generates $100 of income in year 1 from an activity which will generate a corresponding expense of $100 six years later (year 7). If the taxpayer is permitted to accrue the $100 expense, he will report no net income from the activity. But since the taxpayer has the unfettered use of the $100 of income beginning in year 1, at the end of six years he will have substantially more than $100 with which to pay the expense. If he has been able to earn a 12 percent after-tax return on the funds during the six-year period, he will have about $200. The problem lies in the fact that the true cost in year 1 of the future outlay is the present value of the outlay amount, which in this case is about $50. Thus, the taxpayer's true profit in year 1 is $50 ($100 income less the $50 present value of the future expense), and the appropriate tax (assuming a 50 percent tax rate) is $25. Unfortunately, our present income tax system does not reach this result because it does not take into consideration the time value of money.

Conversely, delaying the taxpayer's deduction to year 7 always produces the correct result. In reality what has happened is that the taxpayer has charged $50 for the product sold and $50 to fund his future obligation seven years hence.* This latter $50 will bear a $25 tax in year 1 and the remaining $25 will grow to $50 in year 7, which will equal the taxpayer's net after-tax cost ($100 expense less $50 tax savings) of the obligation in year 7.

While deferring the tax deduction to the year in which the expense is incurred thus produces the correct result, the taxpayer in some cases may have insufficient income in the later year against which to offset the deduction. The net operating loss carryback provisions will not remedy the situation if the taxpayer had insufficient income in the taxable years to which the deduction can be carried back. If

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*A detailed discussion of the effect of the timing of the deduction for the future obligation on the amount charged to fund that obligation is set forth in the attached appendix.

the taxpayer is forced to carry the loss forward, the value of the deduction will decline in present value terms. If relief is considered necessary, then the appropriate solution would be to amend the net operating loss provisions to provide for a longer carryback period in the case of losses of the type at issue here, as has already been done in the case of product liability losses under current law.

A second inequity with deferring the tax deduction may arise when the taxpayer is required to escrow funds currently to meet the future obligation but the taxpayer is not entitled to receive the benefit of a market rate of interest earned on the escrowed funds. However, if the taxpayer is denied such interest on the escrowed funds, his economic disadvantage is caused by the terms of the escrow arrangement rather than by the Federal tax law.

There is precedent in the tax law for reserve accounting methods of the type provided by S. 1911 and S. 2642. The Internal Revenue Code of 1954, as originally enacted by Congress in 1954, contained a provision, section 462, which permitted the accrual of current deductions for future expenses attributable to income generated in the current year. This provision was repealed, retroactively, in 1955. Even though section 462 was consistent with generally accepted accounting principles, the administrative problems and potential revenue losses caused by the provision were found to be intolerable shortly after enactment of the 1954 Code. It was simply impossible to impose any workable limitations on the categories or amounts of the future expenses for which reserves could be established and current deductions claimed, and the potential revenue losses from allowing all similarly situated taxpayers to create and deduct such reserves were unacceptable.

The foregoing discussion makes it clear why Treasury opposes S. 1911 and S. 2642. The mathematical examples show that the denial of current deductions for future reclamation expenses required by Federal or State statutes penalizes taxpayers only to the extent that the taxpayers are unable to obtain immediate tax benefits from the deductions in the year the expense outlays are made. This hardship, if it exists at all, is minimal compared with the unfair advantage that would be given to mining companies by allowing current deductions for the undiscounted amount of the future outlays.

Moreover, the enactment of either of these bills to give special treatment to mining companies would have broad implications with respect to the deductibility of reserves for similar expenses incurred by other taxpayers. If current deductions are allowed for estimates of future reclamation expenses, it would be difficult to deny taxpayers the right to establish reserves for the estimated amount of workers'

compensation costs, product liability and warranty claims, unfunded pension liabilities, costs of dismanteling offshore drilling rigs or decommissioning nuclear power plants, and the like. The past experience with the broad rule of section 462 of the 1954 Code shows that the potential revenue losses from applying this accounting method to similarily situated taxpayers would be prohibitive.

Proponents of S. 1911 and S. 2642 argue that our concerns in this area are rendered moot by the Ohio River Collieries case, and that the legislation merely codifies current law as to the appropriate time to accrue reclamation expenses. We disagree. We believe that Ohio River Collieries was incorrectly decided and that the "all events" test for accruing deductions under current law does not mandate the results provided by the two bills. Rather, we believe that current law allows a deduction for reclamation expenses only when the taxpayer has a present liability to pay for such expenses. However, if legislation is needed to eliminate the uncertainty resulting from the current conflict between the Internal Revenue Service and taxpayers on this issue, the legislation should confirm the correctness of the Service's position and eliminate the ability of mining companies to understate their incomes in the manner allowed by the Ohio River Collieries case. In the interim, we intend to continue litigating cases such as Ohio River Collieries in order to assure consistent application of the "all events" test of present law.

Finally, regardless of the argument that can be made as to the proper time for accrual method taxpayers to deduct future expenses, there can be no debate about the appropriate time for cash method taxpayers to deduct these expenses. The law has been consistently clear that a cash method taxpayer can only deduct an expense when he has actually paid it. We strongly object to the provisions in both S. 1911 and S. 2642 that would permit an exception to this longstanding rule.

Conclusion

Treasury strongly opposes S. 1911 and S. 2642. The bills would permit mining companies to understate their incomes significantly by claiming current deductions for the undiscounted amount of future expense outlays. More importantly, enactment of either bill would open the way for additional legislation to permit other taxpayers to establish reserves for the estimated amount of future expenses associated with current income-producing activities. The bills should not be viewed as merely codifying existing case law in a discrete area.

I would be happy to answer your questions.

Appendix

Analysis of Alternative Tax Treatments Of Deferred Expenses

I. Nature of the problem

It is frequently the case that a current exchange of goods and services entails completion of a future action by the seller. When that future action requires the expenditure of resources by the seller, the question arises as to whether those expenditures should be taken into account in determining the seller's current year pre-tax or taxable income. The correct answer to this question is a rule which ensures that the amount charged by the seller reflects no more than the resource cost of completing the transaction. The purpose of this Appendix is to demonstrate that the present law rule which requires that the seller include in his gross income for the current year the entire proceeds of his sale while deferring to the later year the deduction of the associated expense generally produces the correct result. The analysis also identifies the error implicit in an alternative rule that would permit the seller to currently deduct the future cost.

The exposition following includes: first, a description of the determination of the price to be charged absent the influence of income taxation; second, a measure of the seller's income in the year a sale is made which requires a future year expenditure; third, a demonstration that the present law rule does not affect the current year price charged; and finally, an identification of the logical error in formulation of the alternative rule under which the seller's current year taxable income is measured as the sales price less the future cost of completing the transaction. The facts of the example used in the testimony will be used to provide numerical results.

II. Determining the current year price to be charged a buyer of goods or services when the seller becomes obligated to incur a future expense.

If all a coal mining company must do to produce a ton of coal for sale is mine it and otherwise prepare it for delivery to a buyer, the price charged would have to be sufficient to cover all the expenses incurred in its production: wages of coal miners, the cost of materials consumed in mining, and a gross return to mining company capital sufficient to cover depletion of its reserves, and depreciation of its equipment and to provide a return to its creditors and equity owners. Since the price to cover all these costs of production multiplied by the quantity

mined is reported by the mining company as "gross income," the company is allowed to deduct the wages paid and the cost of materials used up, since these elements of gross income are allocable to those productive agents. The coal company is similarly permitted to deduct depletion and depreciation costs to determine pre-tax income. After the mining company deducts the interest paid creditors--their share of the pre-tax income from capital employed in the mine--the residual is the pre-tax income of equity owners. Taxation affects the cost of mining coal only to the extent it affects the cost of wages or materials or the pre-tax rates of return of creditors and equity owners. So long as costs incurred in simple mining are appropriately measured and allowed as deductions to the mining company, the income taxation of coal mining companies, per se, does not affect the price of coal.

Now suppose that, in addition to incurring these current costs of mining coal for sale, the mining company must also restore the land to some specified condition after mining is completed. Clearly, an additional cost to the mining of coal has been imposed. Since this future reclamation expense is effectively independent of the mining cost, it can be isolated in determinating its effect on the price of mined coal. Let us symbolize the cost to be charged coal buyers for this service as P_1, the subscript indicating that it is a price to be charged in year #1, when the coal is mined.

If we symbolize the future outlay to reclaim the mined land as O_n, the subscript indicating the year when the reclamation outlay will be made, then the only other determinant of P_1 is the discount rate by which the current year charge can be related to the future outlay. Let us call this discount rate, which is the opportunity cost of shifting payment obligations over time, r. Then, ignoring taxation,

$$P_1 = O_n (1+r)^{-(n-1)}. \qquad (1)$$

That is, referring to the example in the testimony, where O_n = \$100, n=7 and r= 0.12, P_1 = \$100(1.12)$^{-6}$ = \$50.66. The seller would have to charge the buyer at least \$50.66 in year #1 so that, 6 years later, he would have accumulated \$100 with which to cover the costs of reclamation (in year #7). From the buyer's point of view, he would pay no more than \$50.66 in year #1 for he could take that capital sum and accumulate it over 6 years to \$100 and, himself, requite the reclamation cost of \$100.

III. The seller's income.

Suppose that the cost assumptions of the above example hold. What is the measure of the coal miner's income in year #1 when he receives the \$50.66? Obviously, with respect to the \$50.66 received for the sale of coal, it is zero: He has simultaneously received a market payment of \$50.66 but

incurred an obligation to cover a future expense the present value of which is exactly equal to $50.66. Therefore, for financial statement purposes, the receipt of the $50.66 has no effect on the company's income statement; but it will have a balance sheet effect. On the balance sheet, the $50.66 will be an increase in assets (earning 12 percent, by assumption) offset by the recognition that there is a future $100 obligation, less a "discount" of $49.34, which represents the 6-year cumulation of earnings of the $50.66. With each passing year, the mining company will record interest income and a corresponding decline in the "discount" associated with the year #7 reclamation obligation. If it does not in fact accumulate among its assets the interest earned, when the $100 outlay is made the mining company will suffer a $49.34 decline in net worth.

IV. Introducing income taxation.

In order to simplify exposition, we shall now assume the r in equation (1) represents an after-tax rate of return to capital employed in the enterprise. There are two income tax formulations for the treatment of P_1 that will give the same result as equation (1): The present law rule, and another rule which applies the result in III, above, namely, that there is zero pre-tax income in year #1.

First, we rewrite equation (1) to introduce an income tax levied at rate m. If T_1 = tax due in period #1 and T_n the tax due in period n,

$$P_1 - T_1 = (O_n + T_n)(1+r)^{-(n-1)}. \qquad (2)$$

Symbolically, equation (2) simply says that P_1, less tax due when it is received, must be euqal to the future outlay, plus tax then due, when the outlay is made in year n, all discounted to the present.

Under present law, which taxes P_1 as received and allows a deduction of O_n in year n,

$$T_1 = mP_1 \qquad (3a)$$

$$T_n = -mO_n. \qquad (4a)$$

If equations (3a) and (4a) are substituted in equation (2), the result is:

$$P_1(1-m)=O_n(1-m)(1+r)^{-(n-1)},$$

which, of course, is exactly the same as equation (1) after cancelling the (1-m). Applying the present law rule to the factual assumptions in the testimony example produces a P_1 = $50.66, and if we take m = 0.40, $20.26 will be paid in tax (T_1=$50.66 x 0.40) leaving the miner a capital fund of $30.40

which will accumulate to $60 in year #7, at which time the miner will receive a refund of $40 ($T_7$ = -$100 x 0.40) enabling him to cover the $100 year #7 cost.

Of course, if the taxpayer is allowed a $50.66 deduction in year #1 against his P_1 = $50.66 to signify his lack of economic income in that year and is not allowed to take a deduction when the expense is incurred in year #7, T_7=0, the same result is achieved as under present law, and neither rule causes an alteration in the charge for reclamation. But note that, in order to apply the latter rule, the present value of the future cost must be determined, and this requires estimation of a discount rate. In contrast, the present law rule which taxes P_1 and refunds with respect to O_n operates only with actual transactional data and requires no discounting.

V. The effect of erroneously permitting the current deductibility of future (undiscounted) costs.

Suppose we define P_1' to be the year #1 charge for future costs to be incurred by the seller under a tax rule that will permit the amount of the future outlay, O_n, to be currently deducted. Then,

$$T_1 = m(P_1 - O_n) \qquad (3b)$$
$$T_n = O, \qquad (4b)$$

and substituting these in eugation (2) and simplifying, we obtain

$$P_1 = O_n[(1+r)^{-(n-1)} - m]/(1-m). \qquad (4)$$

In contrast with P_1 as determined under present law rules for P_1 and O_n, this rule makes P_1' a function of the tax rate m. In general, for all tax rates greater than zero $P_1' < P_1$, the difference being a tax subsidy to benefit the cause of the deferred expense; it results from the deduction of an undiscounted amount O_n, in year #1, and the subsidy increases with the taxpayer's marginal rate.

For example, continuing to use the testimony example in which $50.66 is the true charge for reclamation a buyer of coal should pay, allowing current expensing of $100 would result in the following:

Miner's tax rate:	P_1 Buyer's reclamation charge	Subsidy ($50.66-$P_1$)
0.20	$38.33	$12.33
0.40	17.77	32.89
0.46	8.64	42.02

Of course, if competition does not drive down the reclamation charge to miners' customers, the subsidies will be converted into increased monopoly profits of miners. If for example, a monopolistic corporate miner keeps the charge at $50.66, this will increase its after-tax monopoly profit by $22.69 (=the "refund" on $50.66 of current income, less $100, times 0.46), equivalent to a taxable subsidy to him of $42.02, as shown above.

Senator WALLOP. The next is a panel consisting of Mr. Robert J. Moody, vice president of tax, FMC Corp., Chicago, Ill.; Mr. John Corra, resident manager of Skull Point Mine, from my State of Wyoming, the town of Kemmerer; Mr. Brian J. Kennedy, director of natural resources, Reno, Nev., representing the FMC Corp.; Mr. Bill Baumann, director of the Wyoming Mining Association.

We welcome you all here. Especially my constituents.

Mr. Moody.

STATEMENT OF ROBERT J. MOODY, VICE PRESIDENT OF TAX, FMC CORP., CHICAGO, ILL.

Mr. MOODY. Morning, Senator. Brian Kennedy is on my right, and John Corra is on my left. We are here to support 2642. If I could, I would like to just submit the prepared statement for the record and just make some comments.

Senator WALLOP. By all means. All statements shall be received in their entirety and appreciated.

Mr. MOODY. To give you a little history of the FMC coal mine in Wyoming, the Skull Point Mine is an open pit mine just south of Kemmerer. Before mining could begin in 1976, FMC needed a permit from the State of Wyoming. There were legitimate environmental concerns, the reclamation liability being the principal one. The plan FMC prepared has been submitted to and approved by the State in intimate detail, including how reclamation was to be provided for. John Corra is familiar with where just about every cubic yard of dirt that comes out of that mine is to be placed, and where it has to go when mining is completed.

As you have noted, FMC has posted a bond with the State to make sure that the reclamation work is performed.

There are really three taxes involved in the reclamation issue. First, there is a $0.35 a ton tax that is required to be paid on each ton of coal. Revenue from this tax is used to reclaim abandoned mines. There is no tax issue about the current deduction of that tax. Similarly, there is no issue about the current deduction of the cost of the bond. The whole issue, as you have presented it, is the cost of restoring the land to regional drainage after mining is completed.

The IRS position is that no liability arises until you spend the money; in effect, a cash basis. Our position is that that treatment results in a mismatching of revenue and expense. We have to recover, when the product is sold, not only the cost of mining but also the cost of future reclamation. If we pay tax on the full amount, there is a clear overstatement of income.

I would like to comment just briefly on Mr. Chapoton's time value of money issue. As you properly pointed out, that's a two-sided coin. FMC at year end usually has $500 million or so of accounts receivable. We have not received cash on those accounts receivable, yet they are included in income but they are not discounted for the time value of money.

I do not think I will go into the miner's position anymore. That has been well stated—that there is a current liability created whenever the overburden is disturbed. The liability is there even if FMC does not take a ton of coal out of the mine. Once we have disturbed the overburden, we have the liability. The tax cases support that position. If one were to look at the Skull Point Mine with its 650 pit, it is a little hard—with the bond and everything that we have done with the State—to argue that there is no liability.

The next point I would like to discuss is the reasonable amount argument. Since the Treasury has taken the position that no deduction is allowed, reasonable or not, it is conceivable that once the liability is established, as the court cases have done, that the Treasury would then switch to arguing about the reasonableness of the amount.

I think, as you have pointed out, it's almost a matter of mechanics to determine the amount of the liability set forth in the mining plan. But if it gives comfort, it would seem to me that you might have a presumption that if the amount is determined by an independent mining consulting firm there would be a presumption of correctness. Furthermore, if necessary, you might also require that the taxpayer report to its shareholders at least the same amount of reclamation expense. That way, there would be a break on the amount a taxpayer would claim.

The other issue is how the reasonable liability is to be spread. I think your bill is superior to the other bills in that it does permit the deduction to be determined on the basis of property disturbed. Code section 616 now permits a current deduction of development expenses even though such expenses may be attributable to the full operation of the mine. In the same manner, the cost of removing the overburden should be currently deductible, since the reclamation cost, in a true sense, is also a part of the development expense. There is the cost of removing the overburden, and there is the cost of putting it back. Both costs should be treated the same.

The final point I would like to make is that we think your bill and the other bills that provide for settling prior years tax liabilities on this same basis is a good point and will avoid further litigation over past year's liabilities.

Senator WALLOP. Thank you, Mr. Moody.

Mr. Corra?

Mr. CORRA. I have nothing further to add.

Mr. KENNEDY. I have nothing further.

[The prepared statement of Robert J. Moody follows:]

Statement of Robert J. Moody
Vice President-Tax
FMC Corporation, Chicago, Illinois

Mr. Chairman and members of the Subcommittee, I am Robert J. Moody, Vice President-Tax of FMC Corporation. With me are Brian J. Kennedy, Director of the FMC National Resources Operation and John V. Corra, who is resident manager of the FMC Skull Point coal mine near Kemmerer, Wyoming. We are pleased to appear before you today to testify in support of S.2642.

FMC has operated a surface coal mine at Kemmerer in southwestern Wyoming since 1976. Because of the nature of surface mining and the reclamation requirements imposed upon us by federal and state law, we have had a long-standing, direct concern about the tax treatment of financial reserves created in connection with reclamation costs which will be expended both during the on-going mining of coal and when the coal seam runs out.

In order to mine coal in Wyoming, it is first necessary to obtain a mining permit from the Wyoming Department of Environmental Quality. The application has to contain a detailed reclamation plan in compliance with rules and regulations which conform to the Federal Surface Mining Control and Reclamation Act of 1977. In effect, FMC, like any other mining company, has to commit itself to perform the required reclamation in exchange for permission to mine and a bond has to be posted to guarantee this performance. Brian Kennedy and John Corra are both totally familiar with this process and would be pleased to address any questions you may have on the subject.

This whole reclamation process involves three kinds of reclamation costs. First, the mining company must pay a federal reclamation tax of 35 cents per ton of coal mined. This goes into a fund to reclaim abandoned

mines. There is no tax issue about the current deduction of this amount. Second, the company must pay for a bond to cover the reclamation of its own mine in case it does not perform the required reclamation. Similarly, there is no tax issue about the current deduction of the cost of the bonds. Third, the company must pay for the actual reclamation of the mine. This is where the tax issue arises and involves three basic elements. First, whether a liability exists; second, the amount of the liability; and, third, the method by which the cost of the liability is to be amortized.

Does a Current Liability Exist?

A liability to reclaim occurs as soon as a surface miner disturbs the earth's surface. Since most mines require pre-stripping and pre-construction, a liability is almost always created prior to coal production. If the company stops mining, even before removing a single ton of coal, it must immediately start reclamation. Not one ton of coal could be produced without creating the liability to reclaim and to guarantee faithful performance of that liability.

Notwithstanding these facts, the IRS has taken the position that a liability does not arise until actual reclamation work begins; in effect, after all the coal has been mined and there is no longer any income to offset the expense. The IRS has litigated this position several times and has consistently lost. The courts on each occasion have held that a current liability does exist and have rejected the IRS position to the contrary. In fact, it seems ludicrous to us for anyone who would look at a 650 ft. pit, and be aware of all the guarantees and bonds FMC has given to various governmental agencies to assure them that the pit will be restored to establish original

drainage in the area, to take the position that a liability does not exist. In this regard, S.2642 will reverse the position taken by the Internal Revenue Service and conform the Internal Revenue Code to the position taken by taxpayers and the courts.

Amount of the Liability.

The second issue concerns the amount of the liability. The bill addresses this point by providing for a deduction of a "reasonable addition to any reserve." We are concerned that this may become an area of potential controversy between taxpayers and the Internal Revenue Service; particularly, since the IRS has had a history of opposing any deductions, reasonable or not. Therefore, we would urge that the IRS and taxpayers be given guidance in the statute on what can be "reasonable." For example, we would suggest that there should be a presumption of reasonableness if the estimated costs are based on generally accepted mining engineering practices for calculating reclamation expenses or are calculated by an independent mining engineering firm qualified to make such calculations and/or the amounts are reflected on the financial statements of the taxpayer.

Method for Allocating the Costs.

We believe this is one area where S.2642 is superior to S.1911, since it recognizes that the reclamation costs can be allocated (1) on a per ton basis as the coal is mined or (2) on the basis of the amount of the property disturbed which gives rise to the reclamation liability. We believe S.2642 is correct by allowing this second method of allocation, since it reflects the

facts as they exist. In a real sense, the liability is an additional development cost. The cost of developing the mine involves not only the cost of removing the overburden, which is allowable as a current deduction under section 616 of the Internal Revenue Code, but also the environmental cost of reclaiming the property.

Application to Prior Years.

We also support the provision of S.2642 which permits taxpayers who have accrued reasonable reclamation expenses in prior years to make an election to have that method be treated as a valid method of accounting for tax purposes. As I mentioned earlier, the IRS has forced considerable litigation on this point and, although it has been consistently unsuccessful, it nevertheless persists. This provision will permit taxpayers to avoid the high cost of relitigating the same issue.

We are firmly in support of the bill and urge its adoption. The bill represents a fair application of the tax laws to the treatment of reclamation expenses which a mining company is certain to have to pay. At the same time, it creates certainty for both taxpayers and the Government with regard to how reclamation expenses are to be treated.

We thank the Chairman and the Subcommittee members for this opportunity to appear before you to express our views in support of S.2642.

STATEMENT OF BILL BAUMANN, DIRECTOR, WYOMING MINING ASSOCIATION, CHEYENNE, WYO.

Senator WALLOP. Mr. Baumann.

Mr. BAUMANN. I'm Bill Baumann, a director of the Wyoming Mining Association, and resident manager of Bear Creek Uranium, a mining operation in Cumbers County, Wyo.

You have been provided with written testimony and a series of pictures. And we would like to have these entered into the record.

I will briefly review with you the mining process and the type of work required to reclaim a mine site. Using the photographs provided, you can follow along with those.

First, I would like to reemphasize that the most important part of a mining permitting process is regulatory agency acceptance and approval of final reclamation plan. This liability for reclamation is established before any work is started. The reclamation obligation incurs clearly defined work commitments, costs of which can reasonably be determined. These obligations quite often can swing an investment decision.

We start the mining operation with removal and stockpiling of the top soil, which in Wyoming can vary from a few inches to several feet. In the first picture we see a mining unit. It's called a "scraper" in the process of building a stockpile.

Picture No. 2—we show a topsoil stockpile that has been seeded and stabilized for later use in final reclamation.

Picture No. 3—we have a 17-cubic-yard shovel dumping into the truck with the capacity of 120 tons. The material being removed here is overburden. It's the waste and material lying above the ore zone. The ore zone in this specific mine lay another 100 feet below the level the shovel is sitting on at this time.

The next picture shows the beginning of the ore mining operation. The loading unit here is much smaller. It's a backhoe with a 3½-yard bucket dumping into a smaller truck with a capacity of 35 tons. In this specific bed a total of 13 million cubic yards of overburden was removed in about 18 months, prior to the start of the ore mining operation.

In this picture it shows the mill and office complex. Our ore, of course, is hauled and stockpiled in here. It's shown in the lower part of the picture. At the time this picture was taken, we had about 100,000 tons. We recover about 1½ pounds of uranium oxide from each ton of ore. The remainder of this material is placed into tailing spaces. The dark area, the upper right hand side of the picture.

When the base is filled, this material is covered with 3 meters of overburden from the mines, and then topsoiled and vegetated. The total area of the containment basis is about 130 acres, and will require about 2 million cubic yards of material.

Picture No. 6 shows a truck dumping overburden into a mined out pit. This pit required about 6 million cubic yards to fill it back to the surface. This volume is about 5 percent of the total material Bear Creek will have to handle in its reclamation. And that is approximately 120 million cubic yards.

Picture No. 7—after a pit is filled, the topsoil previously stockpiled is replaced and seeded as shown.

Picture No. 8 gives some idea of the magnitude of our operations and the reclamation requirements. The area shown on this particular picture represents approximately 900 acres or 12 percent of the 7,000 acres in our permit area. The darker green area on the right side is a reclaimed overburden stockpile. And it's about 250 to 300 acres.

The last picture shows a closeup of one pit area that has been completely reclaimed. And native vegetation has been reestablished. Similar growth will occur over the entire mine area once the reclamation process is complete.

At this time I would like to state that in analyzing the economics of the mine project, all costs and reports—that would include taxes as well as the cost for labor, material, and et cetera—delaying the deduction for reclamation expenses could discourage investment in the project.

Thank you for your courtesy.

[The prepared statement of Bill Baumann follows:]

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TESTIMONY BY WILLIAM F. BAUMANN
ON
S. 1911 and S. 2642

Introduction

I am Bill Baumann, General Manager of Bear Creek Uranium Company. Bear Creek is a large uranium mine and mill complex near Douglas, Wyoming, that has been operating since 1977. Bear Creek is owned equally by a utility company, Southern California Edison, and by Rocky Mountain Energy, a mining company.

I am here today both to represent the Wyoming Mining Association, of which I am a Director, and to express my personal concerns as a miner. I feel that the reclamation issue is of vital importance to my industry. The uranium industry has been especially hard hit economically, with employment in Wyoming down 70 percent in the last few years.

I will briefly review for you the mining and milling process and the kind of work required to reclaim a mine site. We shall see that mines face a fixed and certain reclamation obligation, established by federal and state laws and regulations. This obligation incurs clearly defined work commitments, the costs of which can be reasonably determined. The economic consequences of the reclamation obligation are an important part of any mine feasibility study and may, in fact, swing the investment decision. Legislation is needed to codify existing case law, and thus, end costly litigation between the mining industry and the Internal Revenue Service.

Process Description

The delineation of an ore body is done with extensive drilling, which may take several years. Each drill hole must be reclaimed, and this is usually done within a few weeks or months after drilling is completed. At Bear Creek, we have so far identified 11 separate ore bodies.

Mining starts with removal of the topsoil over the ore body. The topsoil must eventually be replaced, so it is carefully stockpiled. The topsoil piles must be contoured to blend with the surrounding terrain and then vegetated. Picture #1, in the book of illustrations I gave you, shows topsoil being hauled to a stockpile. Picture #2 shows such a topsoil pile that has been vegetated.

Next, the material overlying the ore body must be removed. This overburden may be a very large volume requiring months or even years to completely remove. The material is either stockpiled on the surface, to be eventually replaced, or used to backfill another pit that has already been fully mined. Picture #3 shows over burden removal in progress. At Bear Creek, we use a large 17 cubic-yard electric shovel that loads 120-ton trucks.

After the ore is exposed, mining is done, as shown by Picture #4. You can see that a typical pit at Bear Creek is quite large. The volume of ore to be mined is small compared with overburden, but the mining is much more selective and is done with smaller equipment. It may take 6 to 12 months to mine out a typical pit at Bear Creek.

The ore is hauled to a mill where it is processed into uranium oxide, our commercial product. The milling process results in waste material, called tailing, which is placed into a containment basin, shown in Picture #5. The mill's life may be 15 to 25 or 30 years. When the containment basin is filled, it must be covered with a thick layer of protective material, usually clay, and

then contoured and vegetated. The mill, at the end of its life, must be decontaminated, disassembled, removed, and the site restored to its original condition. Also, other site facilities, including offices and maintenance buildings, and site access and haul roads must be fully reclaimed.

In general, each mined-out pit must be completely refilled. At Bear Creek, we try to plan our operations so that an empty pit can be filled with the overburden being removed from another pit. This is usually less expensive than rehandling material from surface stockpiles. Often surface stockpiles must still be used, however, because ore bodies are too far apart. And, of course, the final pit or pits of any project must be backfilled from surface stockpiles. Picture #6 shows one of our 120-ton overburden trucks backfilling a mined-out pit.

After the pit is filled, the original topsoil is taken from its stockpiles and replaced. Then the area is returned to its approximate original contours and seeded, as shown in Picture #7.

To gain an impression of the magnitude of the mine reclamation job, please compare Pictures #8 and #9. Picture #8 shows an aerial view of some of the mining activity at Bear Creek. As you can see, the disturbed acreage is sizeable. In the foreground of the photo is a reclaimed stockpile. Picture #9 is a close up of one pit area that has been completely reclaimed. The landscape has been returned to its natural state, and native flora has been reestablished.

Timing and Cost

The time required for the pit reclamation process I just described depends on the size of the ore body. At Bear Creek, a typical ore body might take three to five years from initial topsoil removal to final reclamation.

The exact life of Bear Creek, however, is uncertain. Existing contracts will expire in 1989. Spot market sales or new contracts might extend the operations beyond that time. On the other hand, our current contracts allow the customers to terminate at any time under certain conditions involving unfavorable prices.

If our production operations should prematurely cease, we must begin full site reclamation including reclamation of whatever pits are open. An independent engineering consultant has estimated that such reclamation would take about five years to complete.

Source of the Reclamation Obligation

The reclamation obligation is fixed by federal and state laws and regulations and by regulators' interpretations of these statutes. To obtain a permit to mine any ore body in Wyoming, for example, the miner must first prepare a comprehensive reclamation plan and have it accepted by the Wyoming Department of Environmental Quality (the DEQ). A mill and tailing containment area must also be covered by an acceptable reclamation plan before being permitted by the U. S. Nuclear Regulatory Commission. If federal acreage is involved on a project, the U. S. Forest Service and the U. S. Geological Survey may also require reclamation plans.

A project must assure its compliance with these plans by posting a performance bond. In Wyoming just this year, however, some allowance has been made for self-bonding by companies that can demonstrate sufficient financial strength.

Annually, the project must report its reclamation status and progress to the Wyoming DEQ. The site is also subject to periodic inspections by state and federal regulators. Civil and criminal sanctions exist for noncompliance.

Determination of the Liability

The reclamation liability exists the moment the land is disturbed. The project has an immediate, legal obligation to restore the site per the approved reclamation plans. The greater the disturbance, the greater the liability.

The cost of the reclamation liability can be reasonably determined. At Bear Creek, we employ a well known engineering consultant, Chapman, Wood, and Griswold, Inc., to annually determine our liability. The consultant calculates the cost and time to fully reclaim the project, all according to sound engineering principles and practices. Such calculations are comparable to those that an independent party would use for negotiating an arms-length agreement to perform the reclamation work under contract with Bear Creek. Our own engineers, of course, keep track of disturbance and reclamation on an ongoing basis, in accordance with our reporting requirements to governmental agencies.

Investment Decisions

The tax treatment of the reclamation liability is an important part of the decision whether to enter a mining investment. The uncertainty surrounding the Internal Revenue Service position could negatively impact the development of new mining projects. If the financial analysis of an investment opportunity assumes that the reclamation liability is to be deducted not when it is incurred but instead when the work is performed, a significantly different present value is indicated. Such an unfavorable tax treatment can swing the investment decision negatively, causing a mine investment to be postponed or even rejected.

Need to Codify Existing Law

Current regulations support the immediate deduction of the reclamation obligation. Regulations require that, for a deduction to be made, the taxpayer establish, with reasonable accuracy, both the existence of a liability and the amount of that liability. As we have seen for Bear Creek, mines incur a federal and state statutory liability to reclaim as soon as disturbance begins. The amount of this liability at Bear Creek is calculated annually by independent professional engineers. Thus, at Bear Creek and other mines, the requirements for an immediate deduction of the reclamation liability are readily met.

However, the IRS, in interpreting these regulations, has taken a confusing and inconsistent position with respect to mine reclamation expenses. This position has not been supported by the courts, and thus, legislation is needed to codify the existing case law to avoid costly litigation in the future.

Thank you for your courtesy and attention during my presentation.

Introduction

I am a director of the Wyoming Mining Association and General Manager of Bear Creek Uranium Company. I will briefly review for you the reclamation work required by federal and state laws to reclaim a mine site.

Mining Process

The mining process consists of removing topsoil, material overlying the orebody, and the ore itself. Picture #1 in the book of illustrations that has been given to you shows topsoil being hauled to a stockpile where it will remain until it is eventually replaced. Picture #2 shows a topsoil stockpile that has been revegetated. Picture #3 shows the material overlying the orebody being removed and the actual mining of ore is shown in Picture #4. You can see that the pit is quite large and, in general, each mined-out pit must be completely refilled.

Milling Process

The ore is processed in a mill where the mineral is separated from the waste material. The waste material is placed into a containment basin, shown in Picture #5. When the containment basin is filled, it must be covered with a thick layer of protective material, usually clay, and then contoured and vegetated.

Reclamation Process

Picture #6 shows the backfilling of a mined-out pit and Picture #7 shows an area returned to its approximate original contour and seeded. To gain an impression of the magnitude of the mine reclamation job, please compare Pictures #8 and #9. Picture #8 shows an aerial view of some of the mining activity at Bear Creek. As you can see, the disturbed acreage is sizeable. In the foreground of the photo is a reclaimed stockpile. Picture #9 is a close up of one pit area that has been completely reclaimed. The landscape has been returned to its natural state, and native flora has been reestablished. These pictures are in the official committee files.

Reclamation Obligation

The reclamation obligation is fixed by federal and state laws and regulations and by regulators' interpretations of these statutes. Compliance with these laws must be assured in advance by posting a reclamation performance bond. The reclamation liability exists the moment the land is disturbed. The cost of the reclamation liability can be determined with reasonable accuracy. At Bear Creek we employ a well known independent engineering consultant to annually determine our liability.

Taxpayer Uncertainty

The tax treatment of the reclamation liability is an important part of the decision to invest in a mine. Current regulations support the current deductibility of the reclamation liability since the liability to reclaim is fixed by federal and state laws, and the cost can be determined with reasonable accuracy. However, the uncertainty in planning mine investments caused by the Internal Revenue Service position could have a negative impact on development of new mining projects.

Conslusion

The position taken by the Internal Revenue Service has not been supported by the courts, and thus, legislation is needed to codify existing case law to avoid costly litigation in the future.

Senator WALLOP. Mr. Moody, have you ever attempted to deduct the time value of money?

Mr. MOODY. No, but perhaps I should.

Senator WALLOP. The precedent has been laid. They should have told you that it's a valid concept.

Mr. MOODY. Well, it would certainly be a complicating feature in the Revenue Code if we did that.

Senator WALLOP. I worry about it as a concept, though I understand there have been certain instances. But it really is a dangerous thought because if you were starting that there seems to be no end of tax that could be levied prospectively. And I'm not sure that's what they want to do or are even talking about. But the concept was mentioned.

How significant is the increase cash flow from being able to accrue reclamation expenses as opposed to deducting them when they are actually done?

Mr. MOODY. Accruing them?

Senator WALLOP. Well, how significant is the effect on our cash flow from being able to accrue the reclamation expenses as opposed to waiting for them when they occur?

Mr. MOODY. Well, it's very substantial. I don't know that I could quantify the dollars and cents of it, but it's a cost that has to be recognized as you are mining currently, and we recognize the liability in reports to the shareholders—that it exists currently. In pricing a product, you have to recover it.

Delaying the deduction until after the mine is closed gives you a deduction when you have no income.

Senator WALLOP. I think in Mr. Chapoton's concept—it would have a virtually unlimited carryback.

Mr. MOODY. I guess that's when you get into time value of money. I mean you pay taxes up front and then you get a carryback. That's the time value of money.

Senator WALLOP. Do you think there's a way of blending their idea of working out a system whereby reclamation expenses will be taken on the basis of present value as a viable alternative for the mining industry in accounting for your reclamation expenses?

Mr. MOODY. Well, I don't think so. I just received the Treasury analysis this morning, and I don't know how they plug into their analysis the fact that there is a loss of cash currently by the overpayment of tax and how that relates to inflation. That may balance out. To ignore inflation—it is going to cost more between the time you incur——

Senator WALLOP. How is that handled? Does that become a tax deduction? I don't know how you do this. Assuming you have an accrual basis and you are deducting them as permitted by court decision in the year, supposing at the end of 10 or 15 years of mining those have been widely underestimated, how are those additional expenses handled?

Mr. MOODY. Well, in our particular case, notwithstanding all the expertise John Corra has at the mine in estimating these expenses, we do get an outside appraisal each year so that if at the end of 1982 we get a determination that the cost will be 100, and then at the end of 1983, we will get an updated estimate as to the cost. It is

developed each year, and that year's inflation is taken into account.

Senator WALLOP. They are given annually, those estimates, or they are updated annually? Are they based on what it would actually cost the company to it or on what it would cost the State to do it if the company failed?

Mr. CORRA. Well, I'm not sure that there's a difference. Senator, it is based on what cost a company would incur doing it itself. I think that those costs are probably lower than what it would cost the State to do because they would have to go out and hire someone.

Senator WALLOP. Are those estimates done on the basis of costs plus some profit tax or are they——

Mr. MOODY. No. They are done on costs.

Senator WALLOP. Costs.

Mr. MOODY. And in today's dollars or at the dollars at the end of each year. And we do not anticipate inflation in determining the costs.

Senator WALLOP. Well, I appreciate your coming here his morning.

Mr. MOODY. It has been a pleasure.

Senator WALLOP. I would ask one other thing. Inasmuch as none of us had seen the Treasury statement and the record will remain open, will you take time to review it and comment from your perspective. I assume they will take time to comment on your testimony from their perspective. If you would do that for us, it would be very helpful.

Mr. MOODY. I certainly will, Senator.

[The comments follow:]

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January 12, 1983

FMC

Hon. Malcolm Wallop
204 Russell Senate Office Building
Washington, DC 20510

Dear Senator Wallop:

At a December 7, 1982 hearing of the Senate Finance Energy Subcommittee on S.1911 and S.2642, the Treasury Department presented testimony in which it opposed enactment of either bill. In the course of the hearings you asked me to submit a statement in response to the Treasury Department position. I am pleased to do so.

The principal argument advanced by the Treasury Department was to the effect that a rule that grants a deduction today for an expense to be paid in the future overstates the true cost of the expense to the extent the rule fails to take into account the time value of money. In theory, that position is correct; however, by isolating the benefit of the time value of money and not considering the companion issue of inflation, the Treasury Department analysis reaches an erroneous conclusion.

In developing the present value analysis, the Treasury Department discounted future expenditures assuming an interest factor of 20 percent[1], which represents an inflation rate of approximately 18 percent and true interest of 2 percent[2], but never took into account in the analysis the fact expenditures delayed 7 years will cost more because of inflation.

For example, Assistant Secretary Chapoton summarized the Treasury Department position by giving the following example:

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[1] 20% interest x 40% tax rate = 12% after-tax rate of return used in the Treasury Department analysis.

[2] It is generally accepted in the financial and banking industries that, over a period of time, long-term interest rates reflect the rate of inflation plus a true interest factor of 2 or 3 percent.

> "Assume the taxpayer generates $100 of income in year 1 from an activity which will generate a corresponding expense of $100 six years later (year 7). If the taxpayer is permitted to accrue the $100 expense, he will report no net income from the activity. But since the taxpayer has the unfettered use of the $100 of income beginning in year 1, at the end of six years he will have substantially more than $100 with which to pay the expense. If he has been able to earn a 12 percent after-tax return on the funds during the six-year period, he will have about $200. The problem lies in the fact that the true cost in year 1 of the future outlay is the present value of the outlay amount, which in this case is about $50.

The first point to make is that a taxpayer could not deduct $100 in year 1 for an expense that actually cost $100 in year 7 unless zero inflation is assumed. It is simply not possible for a taxpayer to substantiate the current deduction of a future expense with reasonable accuracy, as required by law, if he attempts to take into account anticipated inflation over an extended time period. Rather, the deduction allowable in year 1 in the example used by Assistant Secretary Chapoton would be the then current cost of satisfying the liability, $37.04, compared with an expense in year 7 of $100, assuming annual inflation of 18 percent. Alternatively, the expense in year 1 could be $100, but would inflate to $269.95 by year 7, again using the inflation rate of 18 percent inherent in the Treasury Department analysis. In any event, it is unrealistic to compare a $100 deduction in year 1 with a $100 expense in year 7.

Attached as Exhibit A is a schedule based on the same financial assumptions used by the Treasury Department, but with an inflation factor included in the analysis. This analysis indicates that if a miner was allowed to deduct reclamation costs at the time the property was disturbed by surface mining, the cash accumulated by the time the reclamation expense had to be paid would equal the actual amount needed. It would not be double the amount needed as stated by the Treasury Department. Moreover, the second analysis on Exhibit A indicates that the approach delaying the deduction, which the Treasury Department states gives the correct result, does in fact not do so and results in a cash accumulation by the taxpayer which is more than 20 percent short of the amount needed. Therefore, when the effects of inflation are factored into the Treasury Department analysis, it is clear that the Treasury approach does not produce a reasonable tax result, but the enactment of S.2642 would produce a result about as close to theoretical correctness as possible under the present tax system--that is, a system that would allow a miner to take as a tax deduction an amount sufficient to accumulate cash equal to the amount necessary to satisfy his legal obligations to reclaim the land when mining is completed.

In summary, the tax law does not generally take inflation into account nor does it adjust income or deductions by the interest gained or lost as a result of timing differences. Thus, accrual basis taxpayers are required to report accounts receivable at full face value even though collection is deferred, and all taxpayers are limited to depreciation deductions based on cost notwithstanding the differential between the time an asset is purchased and the time deductions for depreciation are allowed. Similarly, taxpayers are permitted to deduct expenses for accrued liabilities for future expenditures at full face value without discounting to present value[3]. Therefore, since the present tax system takes into account neither inflation nor present value determinations, the Treasury Department objection based on a present value determination of reclamation costs, without recognizing the effect of inflation on such costs, is, at the very least, totally biased in favor of the Treasury Department. Moreover, as discussed above, the effect of present value determinations, once separated from the inflationary factor, is relatively minor and would, in theory, be compensated for by competitive pricing of the minerals produced.

I will only briefly address the other basic objection raised by the Treasury Department since this matter was more fully addressed at the time of the hearings. The alleged fear that allowing a current deduction for reclamation costs would require the allowance of deductions for reserves of other taxpayers is not correct since there is a basic difference between the two situations. In the case of reclamation costs, a fixed liability exists; while most of the situations involving reserves are with respect to liabilities that do not currently exist but may arise in the future. For example, when a manufacturer sells a product, he may expect to be liable for a warranty cost but, in fact, there is no liability until the product actually proves defective, if it does. However, in the case of reclamation costs, the liability exists from the moment site preparation for mining begins. Section 462 of the 1954 Code referred to by the Treasury Department covered both situations and was subsequently repealed because of the substantial revenue impact. In contrast, S.2642 deals only with situations where fixed liabilities exist. Deductions of such fixed liabilities have consistently been allowed by the courts and will therefore not adversely affect the revenues. For the Treasury Department to suggest that deductions for fixed liabilities and reserves for potential liabilities may require the same tax treatment is not correct.

Thank you again for the opportunity to testify before the Senate Finance Energy Subcommittee.

Sincerely,

Robert J. Moody

Robert J. Moody
Vice President
Tax

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[3] See, for example, Revenue Rulings 68-643, 69-429 and 77-266 which deal with accrued liabilities for interest, workers compensation, and commissions, respectively.

Exhibit A

Example of Allowing A Current Deduction for Estimated Reclamation Costs with Actual Costs Incurred

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
1) Estimated expense 12/31	$100.00	$ --	$ --	$ --	$ --	$ --	$ --	$100.00
2) Inflation (12 mo.)	-0-	18.00	21.24	25.06	29.58	34.90	41.18	169.96
3) Total deduction	100.00	18.00	21.24	25.06	29.58	34.90	41.18	269.96
4) Tax benefit of deduction @ 40%	40.00	7.20	8.50	10.02	11.83	13.96	16.47	--
5) After-tax portion of sales price to cover reclamation cost (87.75 less 40%)	52.65	--	--	--	--	--	--	--
6) Cash available to invest 1/1	--	92.65	110.97	132.78	158.74	189.62	226.33	--
7) Interest on cash @ 20%	--	18.53	22.19	26.56	31.75	37.92	45.27	--
8) Tax on interest @ 40%	--	7.41	8.88	10.62	12.70	15.17	18.11	--
9) After-tax interest	--	11.12	13.31	15.94	19.05	22.75	27.16	--
10) Total cash 12/31 (lines 4 + 6 + 9)*	92.65	110.97	132.78	158.74	189.62	226.33	269.96	269.96
11) Reclamation liability 12/31	100.00	118.00	139.24	164.30	193.88	228.78	269.96	269.96

* In year 1, items 4 + 5

Example of Not Allowing A Current Deduction for Estimated Reclamation Costs with Actual Cost Incurred

1) Estimated expense 12/31	$100.00	$ --	$ --	$ --	$ --	$ --	$ --	$100.00
2) Inflation (12 mo.)	--	18.00	21.24	25.06	29.58	34.90	41.18	169.96
3) Total deduction	--	--	--	--	--	--	269.96	269.96
4) Tax benefit of deduction @ 40%	--	--	--	--	--	--	107.98	107.98
5) Increased sales price	87.75	--	--	--	--	--	--	--
6) Tax at 40%	35.10	--	--	--	--	--	--	--
7) Cash available to invest 1/1	52.65	52.65	58.97	66.04	73.97	82.84	92.78	92.78
8) Interest on cash @ 20%	--	10.53	11.79	13.21	14.79	16.57	18.56	--
9) Tax on interest @ 40%	--	4.21	4.72	5.28	5.92	6.63	7.42	--
10) After-tax interest	--	6.32	7.07	7.93	8.87	9.94	11.14	11.14
11) Total cash 12/31 (lines 4 + 7 + 10)	52.65	58.97	66.04	73.97	82.84	92.78	211.90	211.90
12) Reclamation liability 12/31	100.00	118.00	139.24	164.30	193.88	228.78	269.96	269.96

Senator WALLOP. Next is a panel consisting of Mr. Tony Gentile, chairman of the Ohio River Collieries, representing the Mining and Reclamation Council of America; Mr. Joseph Nicholls, senior vice president, Drummond Coal Co., representing the National Coal Association; Mr. Dennis Bedell, chairman of the American Mining Congress; and Mr. Pete R. Lasusa, Arthur Andersen.

Good morning, gentlemen. Welcome.

STATEMENT OF TONY GENTILE, CHAIRMAN OF OHIO RIVER COLLIERIES, BANNOCK, OHIO, REPRESENTING THE MINING AND RECLAMATION COUNCIL OF AMERICA

Mr. GENTILE. Good morning. Mr. Chairman, members of the committee, I am Tony Gentile, chairman of Ohio River Collieries Co., Bannock, Ohio, and immediate past chairman of the Mining and Reclamation Council of America. I appear before the subcommittee today on behalf of the members of MARC, a national trade association representing domestic surface coal producers from all coal producing regions of the United States, to testify in support of immediate passage of your bill, Mr. Chairman, Senate bill 2642, the Comprehensive Mining Reclamation Reserve Act of 1982.

The intent of Senate bill 2642 is essentially identical to S. 1911, The Mining Reclamation Reserve Act, introduced earlier in Congress by Senator Arlen Specter. The members of MARC appreciate the recognition of the need for legislative action on this issue by yourself and Senators Specter, Byrd and Symms in introducing legislation in the Senate and Representatives Don Bailey and Austin Murphy of Pennsylvania and others in introducing and supporting similar legislation, House bill 4815, in the House of Representatives.

This legislation would recognize the existing legal right of a surface coal operator who uses the accrual method of accounting to deduct the cost of reclamation in the taxable year in which liability arises. The existing legal right of a taxpayer to elect such tax treatment was recognized most recently in a unanimous decision of the U.S. Tax Court last December. In that decision, *Ohio River Collieries Co.* v. *Commissioner,* 77 T.C. No. 103, December 31, 1981, the Tax Court, in applying applicable law and regulations held that if all the events had occurred that determined the fact of the liability and the amount of liability was determined with reasonable accuracy, the taxpayer may deduct its accrued reclamation costs in the taxable year that liability arises. Although the Justice Department had the record certified to the Sixth Circuit Court of Appeals, it did not file an appeal of the Tax Court's decision.

In light of this existing legal precedent, you may waonder why it is necessary to enact this legislation. The reason, Mr. Chairman, is in spite of a clear holding by the Nation's primary tax tribunal, and two Federal Circuit Courts, the Treasury Department and the Internal Revenue Service continue to contest the legal right of a surface coal operator to take his deduction in computing his Federal tax liability and to challenge and litigate the reasonableness of the deduction.

As president of Ohio River Collieries Co., the petitioner in the Tax Court decision, I incurred substantial costs—in legal fees and

in the allocation of employee time. These costs must be recouped in the price at which Ohio River Collieries sells coal if we are to stay in business. A price which must be competitive with other producers and competing products. The smaller coal operator is in a highly competitive industry, and has generally operated at a loss for the past several years. The existing Treasury-IRS policy, which results in unnecessary expense, adversely impacts on the smaller coal company's ability to operate and remain in business especially under today's market conditions.

Absent enactment of this legislation, coal producers will continue to be forced to incur these expenses and the accompanying aggravation if they wish to take the deduction allowed under law. Although the Treasury Department has been requested to revise its policy to make it consistent with judicial interpretations, it has given no indication that this policy will be modified. It would appear that the Treasury Department and the Internal Revenue Service will continue to disallow accrued reclamation deductions until a case to appeal arises. In the interim, unnecessary costs will continue to be incurred by both the coal operators and the Federal Government.

Thank you, Mr. Chairman.

Senator WALLOP. Thank you very much.

[The prepared statement of Tony Gentile follows:]

STATEMENT

of

MR. TONY GENTILE
OHIO RIVER COLLIERIES COMPANY, INC.
BANNOCK, OHIO

on behalf of

THE MINING AND RECLAMATION COUNCIL OF AMERICA (MARC)

Mr. Chairman, members of the Committee, I am Tony Gentile, Chairman of Ohio River Collieries Company, Bannock Ohio and immediate past Chairman of the Mining and Reclamation Council of America (MARC). I appear before the Subcommittee today on behalf of the members of MARC, a national trade association representing domestic surface coal producers from all coal producing regions of the United States, to testify in support of immediate passage of your bill, Mr. Chairman, S.2642, The Comprehensive Mining Reclamation Reserve Act of 1982.

The intent of S.2642 is essentially identical to S.1911, The Mining Reclamation Reserve Act, introduced earlier in the Congress by Senator Arlen Specter. The members of MARC appreciate the recognition of the need for legislative action on this issue by yourself and Senators Specter, Byrd, and Symms in introducing legislation in the Senate and Representatives Don Bailey and Austin Murphy of Pennsylvania and others in introducing and supporting similar legislation, H.R.4815, in the House of Representatives.

This legislation would codify the existing judicially recognized right of a surface coal operator who uses the accrual method of accounting to deduct the cost of reclamation in the taxable year in which the liability arises. The existing legal right of a taxpayer to elect such tax treatment was recognized most recently in an unanimous decision of the U.S. Tax Court last December. In that decision, Ohio River Collieries Company v. Commissioner, 77 T.C. No.103, December 31, 1981, the Tax Court, in applying applicable law and regulations,[1/] held that if all the events had occurred that determined the fact of the liability and the amount of the liability was determined with reasonable accuracy, the taxpayer may deduct its accrued reclamation costs in the taxable year the liability arises. Although the Justice Department had the record certified to the Sixth Circuit Court of Appeal, it did not file an appeal of the Tax Court's decision.

1/ Section 461(a) of the Internal Revenue Code states the general rule that a taxpayer is allowed a deduction in "the taxable year which is the proper taxable year under the method of accounting used in computing taxable income," and the regulations elaborate on this general provision. For accrual basis taxpayers, section 1.461-1(a)(2), provides:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.***While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

In light of this existing legal precedent, you may wonder why it is necessary to enact this legislation. The reason is, in spite of a clear holding by the nation's Primary Tax Tribunal, and two Federal Circuit Courts, the Treasury Department and the Internal Revenue Service continue to contest the legal right of a surface coal operator to take this deduction in computing his Federal tax liability and to challenge and litigate the reasonableness of the deduction.

As the President of Ohio River Collieries Company, the petitioner in the Tax Court decision, I incurred substantial costs: in legal fees, in the allocation employee time, and in lost use of the amount of the disputed deduction for several years. These costs must be recouped in the price at which Ohio River Collieries sells coal if we are to stay in business. A price which must be competitive with other producers and competing products. As a smaller coal operator in a highly competitive industry, the existing Treasury-IRS Policy, which results in unnecessary expense adversely impacts my company's ability to operate at a profit and remain in business.

Absent enactment of this legislation, coal producers, as myself, will continue to be forced to incur these expenses and the accompanying aggravation if we wish to take the deduction allowed under law. Although the Treasury Department has been requested to revise its policy [2/] to make it consistent with judicial interpretations, it has

2/ See Attached March 11, 1982, letter from Daniel Gerkin, President of MARC, to the Honorable Donald Regan, Secretary of the Treasury.

given no indication that this policy will be modified.[3/] It would appear that the Treasury Department and the Internal Revenue Service will continue to disallow accrued reclamation deductions until an opportune case to appeal arises.[4/] In the interim, unnecessary costs will continue to be incurred by both coal operators and the Federal Government.

3/ See Attached May 13, 1982, response to the March 11, 1982 letter from Mr. William McKee, Tax Legislative Counsel, Department of the Treasury.

Also, Internal Revenue Service National Office Technical Advice Memorandum #7831003, which states, in relevant part:

> It is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the permissibility of reasonable estimates has not been confined to the Third and the Fourth Circuit or has it been limited to reclamation expense situations. However, the service has not indicated that it will follow either the rationale employed or the holdings of any of the above cited decisions.

4/ The Internal Revenue Service has not issued a notice of acquiescence to the Tax Court's decision in Ohio River Collieries Company v. Commissioner.

With respect to the provisions of your Bill, Mr. Chairman, I submit the following points for your consideration.

As mentioned earlier, the question of the accrual and deduction of reclamation expenses is twofold. First, the fact of the liability to reclaim the land must be fixed. The opinion of the Tax Court in the Ohio River Collieries Company v. Commissioner clearly concludes that all the events establishing the fact of the liability to reclaim the land are fixed once the land is disturbed. The requirements of the Federal Surface Mining Control and Reclamation Act of 1977 (SMCRA) impose a fixed liability which must be secured by a bond. Several states have had a similar requirement for a longer period. In my state, Ohio, the liability was established in 1972. The legislation before the Subcommittee would statutorily recognize the fact of the liability.

Second, the amount of the liability must be determined with reasonable accuracy. In the Ohio River Collieries case the IRS stipulated the reasonableness of the reclamation estimate. It is unlikely that such a stipulation will be regularly made. To avoid unnecessary litigation and reduce administrative burdens on the IRS, operators, and the judicial system, I would recommend that either the legislation incorporate a definition of "reasonable" or that guidance be provided in the legislative history. For example, language which provided that the estimated expenses of surface mining land reclamation would be deemed reasonable if made in accordance with current mining,

industrial engineering, and accounting practices would provide guidance and help reduce the administrative burden on the IRS, the taxpayer, and the courts, which, admittedly, do not have the expertise to consider litigation over valuation.

SMCRA facilitates such a definition. It provides that all persons who engage in surface coal mining must obtain a permit prior to commencement of mining operations. Permit applications must contain a reclamation plan which, among other things, outlines the method to be used as well as the costs involved in reclaiming land altered by coal mining activities. A permit is not granted until OSM or the state regulatory authority approves the reclamation plan. A performance bond, sufficient to insure the completion of the reclamation plan should the operator not fulfill its statutory duty must be secured by the coal operator to obtain a permit.

This reclamation plan, required to be submitted by SMCRA, provides a firm and reliable basis for estimating future reclamation costs. Any motivation on the part of coal operators to take excessive reclamation cost deductions on the basis of inflated estimates in the reclamation plan is tempered by the cost of acquiring a performance bond for the projected reclamation expense and the surety industry's requirement to pledge collateral equal to the amount of the bond.

The absence of guidance for applying the term "reasonable" may well frustrate the intent of the legislation by promoting litigation and administrative uncertainty.

An additional point I wish to highlight is that your bill, as Senator Specter's, recognizes the need to provide the same tax treatment for cash basis taxpayers who may choose to set up a reserve account to

meet future reclamation liability. This is an important issue for many smaller coal operators and, as a matter of equity, should be provided for under applicable law.

In conclusion Mr. Chairman, I wish to underscore two points.

First, your legislation does not create new law; it codifies existing law. It will provide significant relief from unnecessary legal and ancillary expenses for surface coal operators, the IRS, and the courts. It will not open a door for other taxpayers to claim similar deductions, since, in the case of coal mine operators, there is a specific fixed liability established and fixed under Federal and State law which is secured by a Performance Bond determined by the regulatory authority.

Second, enactment of this legislation in this Congress will relieve a significant burden on a substantial number of coal operators who are struggling to survive current economic conditions 5/ and help to assure that the United States will continue to have a highly competitive and efficient coal industry.

5/ The most recent Department of Energy statistics indicate that since 1977 the number of small surface coal mines in the United States has declined by 87 percent, from 2918 in 1977 to 1426 at the close of 1980. A small mine is defined as a mine that produces less than 100,000 tons annually.

Mining and Reclamation Council of America

Suite 525 • 1575 Eye Street, N.W. • Washington, D.C. 20005 • (202) 789-0220

TONY GENTILE
Chairman of the Board

DANIEL R. GERKIN
President

March 11, 1982

The Honorable Donald T. Regan
Secretary of the Treasury
Main Treasury Bldg., Room 3330
Washington, D.C. 20220

Dear Secretary Regan:

This past December 31, 1981 the United States Tax Court, in a unanimous decision, held that an accrual basis surface coal operator may deduct accrued reclamation costs for a taxable year when all the events have occurred which determine the fact of liability and the amount thereof can be determined with reasonable accuracy. The court, in this case, Ohio River Collieries Company v. Commissioner of Internal Revenue, 77 T.C. No.103, rejected the position of the Commissioner that such liability can only be deducted in the taxable year in which the expense occurred.

For accrual basis taxpayers this decision is consistent with provisions of legislation which is currently pending before the Congress. H.R.4815, introduced by Representatives Don Bailey and Austin Murphy and S.1911, introduced by Senators Arlen Specter, and Robert C. Byrd both titled the Mining Reclamation Reserve Act of 1981, would provide for the establishment of reserves for mining land reclamation and for the deduction of amounts added to such reserves. This legislation recognizes the fixed liability of surface coal operators, under applicable federal and state laws, to reclaim disturbed land following the completion of mining activity.

The membership of the Mining and Reclamation Council of America (MARC) supports this legislation and is committed to gaining its approval by the Congress. However while this legislation is pending, needless litigation on this issue will likely occur as a result of the Commissioner's position which is contrary to the Tax Court's decision. As a consequence, we request that the Treasury Department take appropriate action to establish the Tax Court's decision as the federal government's position on this issue. Similarly, we urge you to support the Mining Reclamation Reserve Act and to communicate such to the appropriate committees in the Congress.

Your attention to this matter is appreciated.

Sincerely,

Daniel R. Gerkin
President

CC: Reps. Bailey, Murphy
Sens. Specter, Byrd

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

MAY 13 1982

Dear Mr. Gerkin:

This is in response to your letter of March 11, 1982 concerning H.R. 4815 relating to tax accounting for surface mining reclamation expenses.

H.R. 4815 would permit surface mine operators who use an accrual method of accounting to deduct reclamation costs at the time the surface land is disturbed and would permit cash basis taxpayers to deduct additions to a reserve for reclamation costs.

The issues involved in H.R. 4815, principally the proper time to accrue estimated expenses for services to be performed in the future, have arisen in many different contexts. The members of my staff responsible for tax accounting issues are currently studying H.R. 4815 and its effects on this area of the law. It would thus be premature to comment on Treasury's position at this time.

Thank you for bringing your concerns to our attention.

Sincerely,

William S. McKee
Tax Legislative Counsel

Mr. Daniel R. Gerkin
President
Mining and Reclamation Council of America
Suite 525
1575 Eye Street, N.W.
Washington, D.C. 20005

STATEMENT OF JOSEPH NICHOLLS, JR., SENIOR VICE PRESIDENT, ADMINISTRATION, DRUMMOND COAL CO., REPRESENTING THE NATIONAL COAL ASSOCIATION, WASHINGTON, D.C.

Senator WALLOP. Mr. Nicholls.

Mr. NICHOLLS. Thank you, Mr. Chairman. My name is Joseph E. Nicholls, Jr. I am appearing on behalf of the Tax Committee of the National Coal Association and I am senior vice president of Drummond Coal Co.

The NCA supports the concept of Senate bill 2642. For many years, the coal industry has maintained accrued reclamation is a proper deduction for income taxes. Two or three Federal circuit courts of appeal and recently the Tax Court have so held. However, the tax treatment of accrued reclamation appears to be an issue that will not be settled unless specific legislation is passed. The IRS and members of NCA have long been familiar with the pertinent court cases. However, we continue to incur additional costs to fight the IRS disallowance.

On September 21, I personally received another notice from the IRS disallowing $9.5 million of accrued reclamation. This was after the recent Tax Court case. Now my company will incur additional costs, as will the Government. This is an inexcusable waste of both our resources.

The Internal Revenue Code provides an accrual basis taxpayer shall deduct an expense in the taxable year in which the item becomes a liability, and can be reasonably determined. This is the so-called "all events test."

First, is reclamation an incurred liability when the land is disturbed? The coal operators are mandated by both Federal and State law to restore the land it has disturbed. A bond in an amount sufficient to insure completion of reclamation must be provided by the operator before the land is disturbed. In addition, the Federal statute requires that the State impose criminal sanctions, including jail sentences of up to 1 year. Commonsense and my lawyers tell me that coal operators have incurred a liability.

As to the second test—accuracy of the estimate—you should be aware that the estimate of future reclamation is one of the most audited amounts on a coal company's financial records. A substantial number of our members sell coal under long-term sales contracts, which provide for price escalation in the event of Government imposition such as the regulatory cost of reclamation. Since our inventory, accounts receivable—billed or unbilled—accrued liability, income taxes and net income are affected, independent public accountants audit our reclamation costs. Since our customers' pocketbooks are affected, they audit our reclamation costs. We believe the coal industry has available and uses techniques which accurately estimate reclamation costs.

We believe that accrued reclamation meets the all events test imposed by the Internal Revenue Code in the tax year that the land is disturbed. To avoid any confusion as to how to define "reasonably accurate," we suggest that section 467 of Senate bill 2642 be amended to add language to the effect that the estimate shall be deemed reasonable if based on current accounting, mining, and industrial engineering practices.

While we believe the existing body of law, including the Federal Tax Court cases, is clear, we do not believe the IRS is ready to accept it as the law of the land.

As previously mentioned, the IRS has recently disallowed $9.5 million of my company's accrued reclamation expense. The $9.5 million is only 5 to 6 months of actual cash basis reclamation and depreciation of my company. Reclamation costs are important to the coal industry and these costs are over 6 percent of my company's production costs.

I would like to deviate just a second. I would hope the IRS will allow the time value of money on depreciation as well as on the accrued reclamation.

If NCA members are willing to wait for the legal conflicts with the IRS to be resolved, we are confident the coal industry will prevail in its position. However, the evermounting nonproductive costs to the coal industry and the Government and the cloud of uncertainty reclamation places over other areas of operation such as finance has led us to conclude that legislative action is necessary.

NCA would like to express its appreciation to Chairman Wallop for his leadership in this area. And we hope the committee decides favorably on this bill.

Thank you.

Senator WALLOP. Thank you very much, Mr. Nicholls.

[The prepared statement of Joseph E. Nicholls, Jr., follows:]

Statement of Joseph E. Nicholls, Jr.

on

Behalf of

The National Coal Association

My name is Joseph E. Nicholls, Jr.. I am a member of the Tax Committee of the National Coal Association, and Senior Vice President of Drummond Coal Company. We appreciate this opportunity to express our views with respect to the accrual of reclamation reserves as it relates to the coal industry.

The membership of the National Coal Association (NCA) consists primarily of producing coal companies, whose operations comprise over half of the production in the United States. In addition, we number in our membership equipment manufacturers, railroads, coal exporters, consultants, and other coal related industries.

Our comments are related to the Mining Reclamation Reserve Act of 1981 (S.1911) and Comprehensive Mining Reclamation Act of 1982 (S.2642) introduced by Senator Specter and Senator Wallop, respectively. In principal, NCA supports these bills.

For many years the coal industry has maintained that the accrual of costs for reclamation is proper under the Internal Revenue Code (I.R.C.). Three Federal Circuit Courts of Appeals have so ruled. Recently, the U.S. Tax Court reversed its previous position and held that the accrued reclamation costs are deductible for income tax purposes. However, the tax treatment of reclamation costs appears to be one of those issues that will not be a settled issue between the coal industry and Internal Revenue Service (IRS) unless specific legislation is passed.

The IRS and members of NCA have long been familiar with pertinent court cases which we believe supports the coal industry's position on the deductibility of accrued reclamation costs. However, the coal industry continues to incur legal, accounting, engineering, and incremental in-house costs to counter IRS adjustments disallowing the accrual of reclamation costs. I personally received another notice from the IRS, dated

September 21, 1982, disallowing my company's reclamation costs deduction. Not only will my company now incur additional costs but so will the government, i.e., IRS, courts, etc. This is an inexcusable waste of economic resources needed to capitalize industry and operate our government.

ISSUES

My testimony will address whether costs for reclamation meet the requirements of I.R.C. Section 461(a) as interpreted by Section 1.461-1(a)(2) of the Income Tax Regulations in the year the land is distributed and are these costs therefore, deductible in that year by an accrual basis taxpayer ("Current Law") and the proposed acts, S.1911 and S.2642.

CURRENT LAW

Facts:

Coal mine operators are mandated by both federal and state law to restore land that is disturbed by the mining process. The Federal Surface Mining Control and Reclamation Act of 1977, Public Law 95-87, (herein after referred to as the Federal Reclamation Act of 1977) provides that prior to receiving a mining permit each mine operator must submit and receive approval of a reclamation plan which complies with both federal and state law. Pursuant to Section 509(a) of the Federal Reclamation Act of 1977 each mine operator is required to furnish a bond in an amount "sufficient to assure the completion of the reclamation plan if the work had to be performed by the regulatory authority in the event of forfeiture." Note however, that while bonding figures are reasonably accurate, they do not reflect the actual costs and should not be used as a standard for accrual purposes. In addition, this federal statute requires that

the states impose criminal sanctions including jail sentences of up to one year for willful failure to meet statutory reclamation requirements.

A mine operator's obligation to reclaim the land becomes fixed immediately when the land is disturbed. Simultaneously, with the removal of dirt from the seam of coal, the mine operator incurs the obligation for reclaiming the land disturbed by removal of the dirt. For book purposes a mine operator must match the expense of reclamation to the disturbance of the land and the related liability to reclaim the land. Therefore, in conjunction with the creation of the obligation for reclamation the mine operator accrues on his books the costs which will be required in order to reclaim the land which has been disturbed as a result of mining operations. Not only direct reclamation costs, but all mine closing expenses should be permitted to be accrued. These include work required by federal and state law, such as removal of buildings and equipment, the disposal of refuse and the restoration of roads. Also included are the maintenance of air and water quality. With respect to maintenance of water quality, the cost of the function could continue on for years after the mine is closed.

In addition to accounting requirements, several other factors have required the development of reliable and precise engineering techniques to ascertain the costs which will be incurred to reclaim disturbed land. Escalation clauses of many long-term sales contracts permit adjustments in the sales price of coal for increase in accrued reclamation cost. Such increases directly impact cash flow to the mine operator and are subject to intense audit by the coal purchaser. Additionally, as previously mentioned, the taxpayer's estimates of reclamation costs are also used to determine the amount of reclamation bonds which are required to be posted. Finally, mining operators, as prudent business persons, must know what the actual total cost of mining a ton of coal on a current basis is, including reclaiming the land from which the coal was mined, in order to compete in today's highly competitive environment.

Law:

Section 1.461.1(a)(2) of the Regulations provides a two part test, which is to be used by an accrual basis taxpayer in determining the timing of a deduction. This section of the regulations provides that a taxpayer shall deduct an expense in the taxable year in which:

1. All events have occurred which determine the fact of the liability; and

2. The amount of the liability can be determined with reasonable accuracy.

We believe that accrued reclamation costs meets both of these tests for the taxable years in which the land to be reclaimed is disturbed. For purposes of discussion we will address each of these tests separately.

It is our contention that the first of these tests is met each time the land is disturbed and that it is met immediately when the land is disturbed. Pursuant to the requirements of both federal and state law a coal mine operator has a requirement to reclaim all land disturbed in the mining process and that requirement occurs when the land is disturbed.

The U.S. Tax Court in Ohio River Collieries Co. v. Commissioner, 77 TC No. 103, 12-31-81, reversed its earlier position in Harrold v. Commissioiner, 16 TC 134 (1951), revd. 192 F.2nd 1002 (4th Cir. 1951) and is now in concert with the Circuit Courts in regard to satisfaction of the all events test for reclamation liabilities. In Ohio River Collieries, the taxpayer accrued on its books and claimed as a deduction for federal income tax purposes the estimated cost of reclamation work required by Ohio law but not accomplished by the end of the taxable year. The government concluded that the taxpayer's statutory duty to reclaim did not create any liability to pay and that therefore

the estimated costs was not deductible. The court, citing the Ohio law requirement for a strip miner to estimate his reclamation cost and post a surety bond to cover it, held that once strip mining occurs the liability becomes certain and thus the all events test is satisfied.

Previously the 4th Circuit, upon appeal of Harrold, also held that all events necessary to determined the liability occurred in the year that the statutory obligation to reclaim was imposed on the operator. The court was presented with the situation where the taxpayer was required by the law of the State of West Virginia to reclaim the land where the taxpayer had stripmined. The taxpayer deducted the cost to reclaim the land in the year the land had been mined (1945) and the government contended that expense of reclamation work was deductible in 1946 the year the reclamation was performed. In deciding that the reclamation was properly deductible in 1945 (the year the mine was stripped) the Fourth Circuit adopted the approach which has since been widely followed by the courts. It held that the reclamation activity itself was not a prerequisite for deductibility. The court found that "all the facts have occurred which determined that the taxpayer has incurred a liability in the tax year" (in which the operator became obligated by statute to reclaim the disturbed land). The court went on to say that to permit a deduction in the year in which the statutory obligation attached to the mine operators "allocates to each year the proper income and expense and prevents distortion of the taxpayers financial condition in the tax year."

Denise Coal Co. v. Commission. 271 F. 2d930 (3rd Cir. 1959) also addressed the question of the year of the deduction for accrued reclamation expenses. In Denise the taxpayer was required by Pennsylvania law to reclaim land which it had stripmined. The taxpayer estimated the costs of reclaiming the land on which it mined and deducted the cost in 1948 even though the actual reclamation activity was not completed until 1956. The court citing Harrold approved the deductions in the year the mine operator became obligated by statute to reclaim the land. In so holding for the taxpayer the court stated

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that the "Pennsylvania statute imposes a fixed and definite obligation."

The conclusion that the liability for reclamation was fixed in the year that the statutory obligation is imposed was also accepted in Commissioner v. Gregory Run Coal Co. 212F.2d52 (4th Cir. 1954), Cert. denied 348 U.S. 828 (9154) and Patsch v. Commissioner, 208F2d532 (3rd Cir. 1954). Both of these cases involved the question of the proper year of deduction for reclamation expenses accrued by coal mine operators. In both these cases, however, the deduction for the reclamation was denied because taxpayers based the estimate of the amount of the liability on arbitrary and untested rules of thumb and therefore failed to met the "reasonable accurate", test prescribed in part two of Section 1.461-1(a)(2) of the Regulations.

Prior to Ohio River Collieries, the Tax Court had already indicated its approval of the reasoning of the Harrold and Denise decisions in World Airway, Inc. and World Air Center, Inc., Petitioners v. Commissioner of Internal Revenue, Respondent, 62 TC 786 (1974). The Tax Court in World Airways, denied the taxpayer a deduction for an accrual to overhaul aircraft engines at some time in the future. In denying the deduction the Tax Court distinguished World Airways, from Harrold, and Denise, saying that in the Harrold, and Denise, cases the "accruals were allowed because in the taxable years in which the deductions were taken, there had occurred all the operative facts giving rise to the obligation to restore the stripped land."

The position of the court in Harrold, that it is not necessary to actually perform the work in order to be permitted a deduction has been adopted in a number of other decisions outside the area of reclamation as follows:

1. In Scheussler v. Commissioner, 230F.2d722, (5th Cir. 1956), the Fifth Circuit permitted an accrual method taxpayer to deduct in the year of sale the estimated cost of turning on furnaces each year for a period of five years. This case involved a situation where the taxpayer incurred the obligation to turn the furnace off and on for a period of five years at the

time the furnaces were sold.

2. In Pacific Grape Products Co. v. Commissioner, 219F.2d862 (9th Cir. 1955), the Ninth Circuit allowed a seller of food products to deduct in the year of sale, the cost of packaging, and shipping products which had been sold even though the shipping and packaging had not been performed.

3. Gillis v. United States, 402F.2d501 (5th Cir. 1986) involved a situation where as a condition of being permitted to purchase cotton at an artificially low price from a government agency, the taxpayer was required to export an identical amount of cotton at a price below the market value. The court decided that the taxpayer correctly recognized the loss, which would be incurred on the sale of the cotton, in the same years the gain on the purchase was recognized.

The current position of the Internal Revenue Service is apparently set out in the National Office Technical Advice Memorandum #7831003. The Tax Court in Ohio River Collieries, has now clearly stated its position that once strip mining occurs the liability to reclaim, pursuant to applicable law, is fixed. Furthermore, there is only one non Tax Court decision since Harrold, cited in this Technical Advice as support for the position that accrued reclamation does not represent fixed liability. The sole case is Schlude v. Commissioner, 372 U.S. 128 (1963); which involves prepaid income, and the question of the year of inclusion of prepaid income is easily distinguishable from the question of the year of deduction of accrued expenses.

The second part of the test under Section 1.461-1(a)(2) of the Regulations is that the amount of the liability must be determined with reasonable accuracy. We submit that, based on extensive experience and by using generally accepted engineering principles, the coal mine operators are able to compute the amount of accrued reclamation expense with a relatively high degree of accuracy. To avoid any confusion

as to how to define reasonable accuracy we suggest that it be made clear that the estimate shall be deemed reasonable if it is based on current accounting, mining, or industrial engineering practices.

The Fourth Circuit, in Harrold, stated that a liability which meets the all events test is deductible if the amount of the liability "although not definitely ascertained is susceptible of estimate with reasonable accuracy in the tax year." The approach of permitting a reasonable estimate, as opposed to requiring the reclamation activity be complete and the actual cost per unit be known, is the interpretation virtually all courts have applied to the phrase "determined with reasonable accuracy" as it is used in Section 1.461-1(a)(2) of the Regulations. We submit, therefore that the taxpayers have determined the amount of the liability for reclamation with reasonable accuracy.

Conclusion:

Based on the authority, the taxpayers believe that the liability for reclaiming the acres disturbed as of the end of each year in question is both fixed and determined with reasonable accuracy.

While we believe the existing body of law, including three Federal Court of Appeals cases and the recent U.S. Tax Court case, is clear, we do not believe the IRS is ready to accept it as the law. The IRS' National Office Technical Advise Memorandum (#7831003) states:

> "it is acknowledged that the reasonable estimate doctrine of Harrold has been followed in subsequent coal reclamation decisions. It is also acknowledged that the permissibility of reasonable estimates has not been confined to the third and the fourth circuit or has it been limited to reclamation expenses situations. However, the service has not indicated that it will follow either the rationale employed or the holdings of any of

the above cited decisions."

Based on the IRS' actions to date, it appears their strategy is to continue disallowing accrued reclamation deductions hoping to find a friendly court. This process has been and will continue to be expensive to both the coal industry and the Government. This is documented in a letter the National Coal Association received from the IRS earlier in the year, a copy of which is attached to this statement.

We believe the course chosen by the IRS is not only ill-advised but very expensive to the Government. Consider that gross accrued reclamation costs adjustment also have offsetting adjustments:

- Coal inventory value would be reduced.
- Allowed percentage depletion deductions would increase and,
- Gross sales amounts of certain of our members would be reduced.
- Taxpayers expenses increases to legally challenge the reclamation issue.

In the case of my company, the IRS has disallowed a cumulative $9.5 million for accrued reclamation costs. We are at various stages of protesting the disallowances. My best estimate of our offsets would reduce the IRS' cumulative disallowances to $5.5 to $6.5 million (60% to 70%) should it prevail in its position. I think it is worth noting that the $9.5 million represents only 5 to 6 months of actual reclamation cost expenditures (cash basis) and reclamation costs, in the aggregrate, are over 6% of our production costs.

There is also an equity factor that should be considered when dealing with reclamation. The minimum period in which cash expenditures are incurred for reclamation activities after the closure of a mine is five years. Existing tax law provides for a carry-back of net operating losses to the third preceeding year. The probability of having taxable income from a closed operation is nil. Therefore, coal companies will permanently lose some portion of their reclamation costs as a tax deductible expense if a cash basis accounting is required.

NCA members believe that the existing body of law supports the deduction of reclamation expenses on the accrual basis and if we were willing to wait for the legal conflicts with the IRS to be resolved in either the Federal Courts or the Tax Court, the coal industry would continue to prevail in its position. However, the ever mounting non-productive costs to the coal industry and the Government, and the interaction with other areas of coal company operations such as finance brought about by the uncertaintity has led us to conclude that legislative action is necessary.

Washington, DC 20224

National Coal Association
Attn: Robert F. Stauffer,
Vice President and
General Counsel
1130 Seventeenth Street, NW
Washington, DC 20036

Person to Contact:
David L. Crawford
Telephone Number:
(202) 566-3775
Refer Reply to:
CC:C:C:2:1
Date:
30 APR 1982

Dear Mr. Stauffer:

This is in reply to your letter dated March 16, 1982, that has been forwarded to this office. You have asked us to reverse our position with respect to the treatment of the estimated costs of reclaiming strip-mined land. The reclamation liability you refer to is derived from the Federal Surface Mining Control and Reclamation Act of 1977 which, as stated in your memorandum, provides that prior to receiving a coal mining permit each mine operator must submit and receive approval of a reclamation plan which complies with both federal and state law. Pursuant to section 509(a) of the Federal Reclamation Act of 1977, each mine operator is required to furnish a bond in an amount sufficient to assure the completion of the reclamation plan if the work had to be performed by the regulatory authority in the event of forfeiture.

Your thorough and well-documented memorandum will aid us in a review of the issue of whether an accrual method taxpayer, engaged in the business of strip-mining coal, may deduct the estimated cost of restoring land that is disturbed by the mining process, in the taxable year that the land is disturbed. We are evaluating the cases cited in your memorandum; however, at this time it is premature to conclude whether our position will be to appeal the Tax Court decision in Ohio River Collieries Co., v. Commissioner, 77 T.C. No. 103, dated December 31, 1981. The time for appeal in this case does not expire until June 6, 1982. However, it should be understood that our present position on this issue is set forth in LTR 7831003 and our litigating position in Ohio River Collieries, supra.

Thank you for your fine submission and you can be assured that it will receive full and careful consideration.

Sincerely yours,

John L. Crawford

Chief, Corporation Tax Branch

STATEMENT OF PETER R. LASUSA, ARTHUR ANDERSEN & CO., NEW YORK, N.Y.

Mr. LASUSA. Good morning. My name is Peter Lasusa. I'm a partner in the accounting firm of Arthur Andersen & Co. I have been asked to review the tax and accounting status of mine reclamation expenditures and I am appearing today on behalf of Bear Creek Uranium Co. located in Wyoming.

I will not read my entire testimony, but will only highlight the principal points.

However, I would like my complete written testimony put into the record.

While we are representing Bear Creek Uranium, I feel the positions set forth are applicable to the entire mining industry. I will limit my comments to Senate bill 2642, since it incorporates the provisions of S. 1911 and, in addition, provides an approach that is soundly based upon Treasury regulations and court cases and the immediate recording of the liability is consistent with generally accepted accounting principals.

Under both Federal and State laws, surface mine operators are required to reclaim the land that has been disturbed by the mining process. Under these rules, the operator has a fixed and certain legal liability to pay the costs of reclaiming the land, and that obligation arises as soon as the land is disturbed.

Today, the mining industry, which is critical to our Nation's economic well-being, is in a depressed state. The uncertainties involved in mining operations, together with its capital requirements, make this industry a high-risk business. One of the problem areas which S. 2642 will help to solve involves the ability to generate needed capital to fund mine projects. Allowing taxpayers to deduct their reclamation costs when the liability is incurred will have a beneficial impact on the industry's cash flow. In view of the foregoing, I believe that this is an appropriate method of deducting such costs from a tax standpoint.

The controversy between the IRS and the surface mining industry has created uncertainty as to the proper tax treatment of reclamation costs. This uncertainty has had a negative impact on our Nation realizing the full potential of our natural resources. In analyzing the financial aspects of a mine project, the tax treatment of reclamation costs can be a significant factor in determining whether or not a project is economically sound. Rather than risk litigation with the IRS, taxpayers in evaluating their cash flow and other financial aspects of a particular mining venture would likely apply the IRS's method of handling such costs with the result that many projects are found to be uneconomical and thus are shelved. I do not believe that such results are consistent with our national goal of energy independence.

Enactment of S. 2642, which is intended to codify the current case law, will eliminate a significant area of uncertainty in planning mining operations; thus reducing some of the risks enherent in the industry.

Senator WALLOP. Mr. Lasusa, could I ask you please to interrupt yourself. I'm sorry to do this. I've got the chairman of the Energy Committee working a bill that's of interest to us up there for many

of the same reasons. Let's recess for a couple of moments. I'm going to declare a recess for 10 minutes with your indulgence. And I appreciate it. If anybody has a plane to catch, you might better let me know now and we can have your testimony submitted. But I will try to be as brief as I can. Thank you.

[Whereupon, at 11:15 a.m., the hearing was recessed.]

AFTER RECESS

Senator HEINZ. As the Chair understands it, Mr. Lasusa was in the process of testifying and Mr. Bedell remains to testify from this panel.

Mr. Lasusa, would you please proceed?

Mr. LASUSA. For accounting purposes, a liability is recorded as soon as its existence is certain even if the exact amount of the liability and the date payable is unknown. Thus, generally accepted accounting principles require that the reclamation costs that will be incurred to comply with the mine operator's liability be reported as soon as the liability exists, that is, when the land is disturbed.

This same concept is provided in Treasury regulations relating to the timing of tax deductions for accrual basis taxpayers. Under tax regulations, an accrual basis taxpayer may deduct an expense in the year that the fact of liability is established so long as the amount of the liability is then susceptible of reasonable determination.

Under Federal and State law, a mine operator has a fixed requirement to reclaim all land disturbed. The first requirement of the regs that is, that the liability be established is met immediately when the land is disturbed. The second requirement of the regs, that is, that the amount of the liability be determined with reasonable accuracy, is satisfied through engineering studies or through consultation with experts in reclamation work. The cost of the liability should be redetermined annually based upon facts and circumstances in existence at year end.

Despite its own regs, the IRS has taken the position that reclamation costs are deductible only when the reclamation work is actually performed. This position effectively puts all taxpayers on a cash basis with respect to mine reclamation expenses. The courts have tended to reject the IRS' position and have recognized the validity of deducting accrued reclamation costs when the obligation becomes fixed, that is, when the earth is disturbed.

This legislation would eliminate the uncertainty caused by the failure of the Internal Revenue Service to follow its own regulations and the decisions of the courts.

We strongly urge Congress to codify the rule of the regulations and the current case law. The position taken by the Internal Revenue Service is not consistent with the tax law nor with the fundamental accounting principle that a liability should be recorded when known. The need for development of our natural resources and for restoration of our lands disturbed by surface mining makes it imperative that we do not permit disincentives of these national priorities.

In conclusion, we believe that the court of appeals in Denise Coal Co. sets forth our views quite succinctly. "We think it is good business and good accounting, and, therefore, ought to be good tax law to allow a reasonable estimate to be set up as a reserve for the fulfillment of this statutory obligation."

Thank you for your courtesy and attention during my presentation.

Senator HEINZ. Mr. Lasusa, thank you very much.

[The prepared statement follows:]

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TESTIMONY BY PETER R. LASUSA
ON
S.1911 AND S. 2642

INTRODUCTION

Good morning. My name is Peter R. Lasusa. I am a partner in the accounting firm of Arthur Andersen & Co. I have been asked to review the tax and accounting status of mine reclamation expenditures and I am appearing today on behalf of Bear Creek Uranium Company. While we are representing Bear Creek Uranium Company, I feel the positions set forth below are applicable to the entire mining industry. Thank you for giving me this opportunity to speak before this subcommittee on an issue of great importance to our nation's mining industry.

Arthur Andersen & Co. has had significant financial and tax accounting experience in the mining industry. Our clients include many of the nation's major mining companies. I, myself, have been involved in the financial and tax aspects of the mining industry for over 14 years. During the past several years, I have been the firm-wide industry head for mining which involves consultation with other professionals on mining industry questions, as well as serving as an expert witness in arbitration matters relating to mining.

S. 1911 and S. 2642

This subcommittee is addressing two pieces of legislation which deal with the tax treatment of mine reclamation expenditures; namely, the Mining

Reclamation Reserve Act of 1981 (S. 1911) introduced by Senators Arlen Specter and Robert C. Byrd, and the Comprehensive Mining Reclamation Reserve Act of 1982 (S. 2642) sponsored by Senator Malcolm Wallop and cosponsored by Senator Steven D. Symms. The principal difference between the two bills involves the methods used to recover the costs of reclamation once the liability has been established. S. 1911 would permit mine operators to deduct the accrued reclamation costs ratably over the life of the mine. S. 2642 would maintain the flexibility allowed under the current tax law. It would give taxpayers the option of deducting the costs of reclamation (i) on an "as disturbed" basis, i.e., the deduction is allowed only to the extent that the land is disturbed at year-end, or (ii) on a ratable basis.

I will limit my comments to S. 2642, since it incorporates the provisions of S. 1911 and, in addition, provides an approach that is soundly based upon Treasury regulations and court cases, and the immmediate recording of the liability is consistent with generally accepted accounting principles.

RECLAMATION LAWS

Under both Federal and state laws, surface mine operators are required to reclaim the land that has been disturbed by the mining process. A mine operator cannot begin mining until his comprehensive reclamation plan has been approved. Generally, the operator must post a performance bond to guarantee that the approved reclamation plan will be carried out. Noncompliance can result in civil and/or criminal penalties. Under these rules the operator has a fixed and certain legal liability to pay the costs of reclaiming the land and that obligation arises as soon as the land is disturbed.

IMPACT ON THE MINING INDUSTRY

Today, the mining industry, which I believe is critical to our nation's economic well-being, is in a depressed state. The uncertainties involved in mining operations, together with its capital requirements, make this industry a high risk business.

One of the problem areas which S. 2642 will help to solve involves the ability to generate needed capital to fund mine projects. Allowing taxpayers to deduct the reclamation costs when the liability is incurred will have a beneficial impact on the industry's cash flow. In view of the foregoing, I believe that this is an appropriate method of deducting such costs from a tax standpoint.

Furthermore, the long-running controversy between the Internal Revenue Service and the surface mining industry has created an atmosphere of uncertainty as to the proper tax treatment of reclamation costs. This uncertainty has had a negative impact on our nation realizing the full potential of our natural resources. In analyzing the financial aspects of a mine project, the tax treatment of reclamation costs can be a significant factor in determining whether or not a project is economically sound. Rather than risk litigation with the Internal Revenue Service, taxpayers, in evaluating the cash flow and other financial aspects of a particular mining venture, would likely apply the Internal Revenue Service's method of handling such costs with the result that many projects are found to be uneconomical and, thus, are "shelved." I do not believe that such results are consistent with our national goal of minerals and energy independence.

Enactment of S. 2642, which is intended to codify the current case law, will eliminate a significant area of uncertainty in planning mining operations; thus, reducing some of the risks inherent in this industry.

ACCOUNTING RULES

For financial accounting purposes, a liability is an obligation that must be satisfied through the disbursement of assets or the performance of services. A liability is recorded as soon as its existence is certain. Even if the exact amount of the liability and the date payable is unknown, once the existence of the liability is certain it should be recorded. Thus, with respect

to mine reclamation expenses, generally accepted accounting principles require that the costs that will be incurred to comply with the mine operator's liability to reclaim the land, be recorded as soon as the liability exists, i.e., as soon as the land is disturbed.

TAX LAW

This same concept -- the fact that a liability exists even though the exact amount and date payable may be uncertain -- is provided in the Treasury Regulations relating to the timing of tax deductions for accrual basis taxpayers. Treasury Regulation §1.461-1(a)(2) provides that an expense is deductible in the tax year in which:

1. All events have occurred which determine the fact of liability; and

2. The amount of the liability can be determined with reasonable accuracy.

Thus, under existing income tax regulations, an accrual basis taxpayer may deduct an expense in the year that the fact of liability is established so long as the amount of the liability is then susceptible of reasonable determination.

Pursuant to the requirements of both Federal and state law, a mine operator has a fixed requirement to reclaim all land disturbed in the mining process, and that liability arises when the land is disturbed. The first requirement of the regulations, i.e., that the liability be established, is met immediately when the land is disturbed. The second requirement of the regulations, i.e., that the amount of the liability be determined with reasonable accuracy, is satisfied through engineering studies or through consultation with experts in reclamation work. The cost of the liability should be re-determined annually based upon facts and circumstances in existence at year end.

Despite its own regulations, the Internal Revenue Service has taken the position that reclamation costs are deductible only when the reclamation work is actually performed. This position effectively puts all taxpayers on a cash basis with respect to mine reclamation expenses. The courts have tended to reject the Internal Revenue Service's position and have recognized the validity of deducting accrued reclamation costs when the obligation becomes fixed, i.e., when the earth is disturbed. See Denise Coal Company v. Commissioner, 271 F.2d 903 (3rd Cir. 1959), Commissioner v. Gregory Run Coal Co., 212 F.2d 52 (4th Cir. 1954), cert. denied 348 U.S. 828 (1954), and Patsch v. Commissioner, 19 T.C. 501 (1952), aff'd 208 F.2d 532 (3rd Cir. 1953). Recently, the Tax Court in Ohio River Collieries Co. v. Commissioner, 77 T.C. No. 103, reversed an earlier decision, Harrold v. Commissioner, 16 T.C. 134 (1951), rev'd 192 F.2d 1002 (4th Circ. 1951), and its position is now in accord with the United States Courts of Appeals that have decided the issue.

This legislation would eliminate the uncertainty caused by the failure of the Internal Revenue Service to follow its own regulations and the decisions of the courts.

CONCLUSION

We strongly urge Congress to codify the rule of the regulations and the current case law. The position taken by the Internal Revenue Service, that a taxpayer may not deduct its accrued reclamation obligation until the reclamation work has actually been performed, is not consistent with the tax law. It is also inconsistent with the fundamental accounting principle that a liability should be recorded when known, i.e., when the land is disturbed and when it can be fixed in an amount with reasonable accuracy. The need for development of our natural resources and for restoration of our lands disturbed by surface mining makes it imperative that we do not permit disincentives of these national priorities.

In conclusion, we believe that the Court of Appeals in Denise Coal Company, supra, sets forth our views quite succinctly. "We think it is good business and good accounting and, therefore, ought to be good tax law to allow a reasonable estimate to be set up as a reserve for the fulfillment of this statutory obligation."

Thank you for your courtesy and attention during my presentation.

STATEMENT OF DENNIS P. BEDELL, CHAIRMAN OF TAX COMMITTEE, AMERICAN MINING CONGRESS, WASHINGTON, D.C.

Senator HEINZ. Mr. Bedell.

Mr. BEDELL. Thank you, Mr. Chairman. I am Dennis Bedell. And although I appreciate the efforts of the staff on the witness list to elevate me to chairman of the American Mining Congress, I should note I am chairman of the tax committee of the Mining Congress.

Senator HEINZ. So noted.

Mr. BEDELL. I do appreciate the opportunity to appear before you today on behalf of the Mining Congress.

I think it is very important to keep in mind what we are talking about with these bills dealing with the treatment of mine reclamation expenses. We are not talking about enacting some major new deduction which is not permitted by present law. Rather, we are talking about a codification of rules that have been developed by the judiciary merely for the purpose of eliminating needless controversy and needless expense both to the Government and to the taxpayers in the administration and compliance with our laws.

The other witnesses in their oral testimony and their statements have well documented the Revenue Service's challenges of taxpayers' deductions for mine reclamation expenses. It is very clear that the Revenue Service is going to continue the challenge. Secretary Chapoton in his statement this morning quite clearly noted that and indicated the challenge would continue.

Given, however, the judicial treatment of these expenses, the growing importance and magnitude of the expenses to the industry and their significant impact on all of mining, but most particularly the coal industry, we respectfully suggest that there is no need for there to be this further needless controversy between the Government and taxpayers. We certainly appreciate the efforts that have been made by Senators Wallop and Specter and Congressman Bailey and others to do away with this continuing, but unnecessary controversy.

Now Senator Wallop noted in his opening remarks that his bill, S. 2642, differs from the other bills that have been introduced essentially in one respect in that it also allows taxpayers the option of following the judicially approved rule of deducting expenses under the as-disturbed method. We think it is important that any legislation that is enacted include that option as well.

There are two other technical points I would like to briefly note. One is that under the Surface Mining Control and Reclamation Act of 1977 the surface mining reclamation requirements are imposed equally where the surface is disturbed by underground mining as well as by surface mining. Because the reclamation burden is also imposed in that situation, it seems entirely appropriate that the bill's treatment should extend to those cases where the surface disturbance has been caused by underground mining.

Our second technical comment concerns the test of the bill which requires that the amount of expenses be estimated with reasonable accuracy is concerned. We don't have any problem with that test in itself. It is a reasonable requirement. But we are concerned that this might be an area for further disputes between the Revenue Service and taxpayers. And, therefore, we respectfully suggest that

it would be helpful if the committee, in its committee report, gave guidance as to the intent behind and what is contemplated by this test. Something to the effect that where the taxpayer had prepared its estimate of reclamation expenses in accordance with generally accepted mining engineering principles or generally accepted accounting principles or if it had the estimate prepared by an independent, outside mining firm, that estimate would be presumed to be reasonable in the absence of other circumstances.

Finally, Mr. Chairman, I would like to comment on the Treasury's—what I call their flood gates argument. Namely, if something is done with respect to the treatment of mine reclamation expenses, then a whole host of other things also will have to be dealt with.

Most economic activity that is the subject of legislation is in fact a continuum of activity. It's not one little discreet box. Indeed, the very process of legislation is drawing the line at a reasonable point on that continuum of activity to define what is within or without the scope of the legislation.

We very respectfully suggest that the approach taken by S. 2642 draws the line on this continuum or spectrum of activity at a reasonable place considering the various unique factors which characterize mine reclamation expenses. And by acting with respect to this type of expense, the Congress is not automatically committing itself to act in a similar manner with respect to a whole host of other types of expenses.

Thank you, Mr. Chairman.

Senator HEINZ. Thank you very much, Mr. Bedell.

[The prepared statement of Dennis R. Bedell follows:]

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STATEMENT

OF THE

AMERICAN MINING CONGRESS

TO THE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

BY

DENNIS P. BEDELL

CHAIRMAN, AMERICAN MINING CONGRESS TAX COMMITTEE

DECEMBER 7, 1982

Mr. Chairman and Members of the Subcommittee:

My name is Dennis P. Bedell. I am Chairman of the Tax Committee of the American Mining Congress and a member of the Washington, D. C. law firm of Miller & Chevalier, Chartered.

I am appearing before you today on behalf of the American Mining Congress. We appreciate this opportunity to testify with respect to the bills which have been introduced by

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the Chairman, S. 2642, and by Senator Specter, S. 1911, with regard to the tax treatment of mine reclamation expenses.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U. S. companies that produce most of the nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

The American Mining Congress appreciates the efforts of the Chairman and Senator Specter to statutorily clarify the tax treatment of mine reclamation expenses and, thus, to eliminate the needless controversies regarding the treatment of these expenses which continue to arise between mine operators and the Internal Revenue Service. In general, S. 2642 seeks to accomplish this objective by including within the Internal Revenue Code the standards which the courts have developed with respect to the proper time for accruing mine reclamation expenses. To a large extent the bill would codify these traditional interpretations and thus remove from the realm of controversy the questions which can arise when the general standards of the Internal Revenue Code for the accrual of an expense are applied. S. 1911 in general follows the approach of S. 2642 except that it would not permit mine operators to use one of the accepted methods for accruing mine reclamation expenses.

In essence, the problem which arises under present law results from the fact that mine operators are required by federal and state law to reclaim surface land which their mining operations have disturbed. Indeed, under the federal surface mining laws, a mine operator prior to beginning its mining operation must formulate and have approved a comprehensive mining reclamation plan, as well as post a performance bond to assure that the activities contemplated by the mine operator's plan in fact will be performed by the mine operator.

Thus, when a mining operation begins, it is clear that the mine operator will be liable for the reclamation and restoration of the disturbed land. Since the reclamation activity will not take place until a point in the future, the actual expenditures for the activity will not be made until that future time. Under the generally applicable principles of the Internal Revenue Code, however, a future expense is properly accruable, and hence deductible, in the current year if the taxpayer's liability for that expense is presently established and the amount of the expense can be estimated with reasonable accuracy. As Mr. Nicholls testified on behalf of the National Coal Association, in applying these general principles the courts have found them satisfied in a number of instances with respect to mine reclamation expenses. Indeed, the most recent case, the 1981 Tax Court case of Ohio River Collieries Company clearly found that a reclamation requirement

imposed by state law satisfied the requirements for current deductibility of the estimated future mine reclamation expenses.

The importance of the issue in question--the current deductibility of future mine reclamation expenses--has grown significantly over the years principally as a result of two factors. First, there have been substantial changes at both the federal and state level in the legal framework governing mine reclamation. The requirements and standards imposed on mine operators with respect to their liability to reclaim land which they have disturbed by their mining operations have been very substantially strengthened and broadened. Secondly, the energy shortages which the country has faced in recent years have resulted in a larger amount of surface coal mining operations as the country attempts to meet some of its energy needs with this very abundant domestic energy resource.

Since the treatment of mine reclamation expenses is an increasingly significant and important issue for mine operators and in view of the manner in which the courts have construed the accrual deductibility requirements of present law with respect to the treatment of mine reclamation expenses, it does not make any sense from the standpoint of sound and efficient tax administration or tax equity and fairness for this to continue to be an area of dispute between taxpayers and the Internal Revenue Service. It must be remembered that although the Ohio River Collieries Company case is of recent vintage,

similar judicial authority for the current deductibility of future mine reclamation expenses has existed for many years. Moreover, the existence of the mine operator's liability for the expenses is clear since that liability is established by law and is reinforced by the performance bonds which are required to be posted. Moreover, the mining and mining engineering industries have had substantial experience with mine reclamation activities and, accordingly, have the ability to formulate reasonable estimates of the cost of future mine reclamation expenses.

S. 2642 would substantially eliminate the areas of controversy by providing that taxpayers will be allowed a current deduction for specified future reclamation expenses under either of two options, both of which reflect accrual methods the courts have found acceptable. First, a taxpayer could currently deduct the amount of its estimated future reclamation expenses which were allocable to the minerals mined during the current taxable year. In essence, this option allows the mine operator to deduct its estimated reclamation expenses for a mine ratably over the production from that mine. Under the second alternative, a taxpayer would be allowed to currently deduct the estimated expenses for reclamation of that part of the mineral property which was disturbed by surface mining activity in the current year. Essentially, this alternative would allow the mine operator to currently deduct the estimated

future mining expenses for which it became liable in the current year by virtue of its present mining activities.

Either of these alternatives will result in a clearer reflection of a mine operator's income than is the case under the position maintained by the Revenue Service which requires a mine operator to wait to deduct the expenses of reclaiming a mine until it has completed its mining activities on that property and, accordingly, has realized its income with respect to that mine. In effect the Revenue Service's position requires the taxpayer to currently realize income from the mining activity on the mine, but to wait until the mine is closed to deduct an expense that legally results from that same mining activity, namely, the expense of reclaiming the property.

As previously indicated, Senator Specter's bill would not allow the taxpayer the second option of deducting future reclamation expenses on an as-disturbed basis. Since this method of accrual has been permitted by the courts, we believe it is appropriate that any legislation on mine reclamation expenses should continue to permit this method of accrual as does Senator Wallop's bill.

There are two additional aspects of the bills on which I would like to briefly comment. First, the bills do not apply where the surface reclamation is required as a result of underground mining. It would appear that this is an inadvertent omission since the reclamation requirements of the Surface Mining Control and Reclamation Act of 1977 are just as applicable

when the surface disturbance results from underground mining as when it results from surface mining. Accordingly, we recommend that S. 2642 be amended so it is also applicable to surface reclamation required as a result of underground mining. Second, for a future reclamation expense to be currently deductible under S. 2642, it is provided that the amount of the expense must be estimated with reasonable accuracy. The American Mining Congress is concerned that this test may generate an undue amount of further controversy. We do not quarrel with the test itself or the need for it but rather with the way it potentially might be applied by the Internal Revenue Service. Accordingly, we believe it would be extremely helpful if the Committee would indicate in its committee report on the bill that a taxpayer's estimate of future reclamation expenses will be considered (or presumed) to meet the reasonable accuracy test, if the estimate is formulated in accordance with generally accepted mining engineering practices or generally accepted accounting principles or is formulated by an independent mining engineering firm. Guidance of this nature would substantially narrow any remaining area of future controversy and would allow S. 2642 to achieve its intended purpose of eliminating needless controversy between mine operators and the Internal Revenue Service regarding the proper time for deducting mine reclamation expenses.

Senator HEINZ. Mr. Bedell, let me ask you this: Under the *Ohio River* case the court allowed accruing of reclamation expenses on the as disturbed basis because all of the conditions of deductibility had been met. Is there any danger that if a mining company does not take those expenses when those conditions are met that they would ultimately lose the deductions altogether?

Mr. BEDELL. Well, that's entirely possible, Senator. The deductions, if they are not taken currently but wait until the end of the mine—there may not be sufficient income against which those may be offset even under some type of extended carryback. Also, there is a cash flow affect on delaying the deduction until the end of the period that can have a very significant affect on the ability of the miner to continue its mining operation during the period before those expenses are reached.

Senator HEINZ. And the chairman is back.

Senator WALLOP. Thank you for taking care of those 10 minutes.

Not being aware of what questions Senator Heinz asked, I won't go into—I would ask you as well if you could look at the testimony of the Treasury.

Mr. LASUSA. Senator, the Treasury suggested that there should be a discount. If you look at what the interest rate is, it is really composed of two things. It's composed of a payment for money, which his economists tell us is 2 to 4 percent, plus an inflation expectation. Since they estimate the cost of reclamation currently without taking into effect the inflation that will develop, if you do that in the discounting process you would have to also ignore the inflation so the discounting that he referred to would be a very nominal amount.

Senator WALLOP. Are those estimates based on the life of the project?

Mr. LASUSA. Your current cost. So that Treasury would not gain very much. They ignore inflation on both sides.

Senator WALLOP. So when you make the mining plan, you base your reclamation costs on the basis of if we were to do it all today it would cost this amount.

Mr. LASUSA. Yes.

Senator WALLOP. All right.

Mr. NICHOLLS. I believe even a more significant point—I think I can speak without exception for my company. We would gladly give up the reclamation deductions if Treasury would be consistent and apply the present value concept to our plan, which was bought up to 30 years ago. And we obviously are not recovering the same cost dollar. And even in the reclamation reserve itself, a significant piece of our costs is depreciation of equipment pushing the soil around. So that I would assume should they prevail, we would get a step up in depreciation that at least as it relates to the reclamation or the depreciation included in a future year that was bought in a prior year.

Senator WALLOP. You would presume that?

Mr. NICHOLLS. I would presume.

Senator WALLOP. I wouldn't hold my breath if I were you. [Laughter.]

Mr. NICHOLLS. No. Their actions are not habit forming.

Senator WALLOP. I have a little bit of a problem in tossing that concept around. As I expressed earlier, the present value of money extended very far could work to their very distinct disadvantage if it were contested as a precedent as well as a lot of other things that are troubling about it.

Well, I appreciate all of you being here. And I am sorry I had to leave and delay you.

The last panel consists of Mr. Steven Friedman; Mr. Marc Feller, Esq., representing Pennsylvania Coal Mining Association; Mr. Robert Penoyer, a coal operator from Cleveland; Mr. W. H. Rose, tax director and assistant secretary of the Arch Mineral Corp.

Mr. BRAVERMNAN. Mr. Chairman, my name is Stephen Bravermnan. I am associated with Mr. Friedman's law firm. Mr. Penoyer of Clearfield, Pa., is the chairman and chief executive officer of SRP. He will testify on behalf of the Pennsylvania Coal Mining Association.

STATEMENT OF ROBERT PENOYER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF SRP COAL CO., CLEARFIELD, PA.

Mr. PENOYER. Mr. Chairman, my name is Robert Penoyer, and I appreciate the staff moving me to a larger area, but I am from Clearfield, Pa.; not from Cleveland, Ohio.

I am the chief executive officer of the SRP Coal Co. And SRP is a small coal company—surface mining—founded by my father, and we produce less than 50,000 tons of bituminous coal annually. I have been in the coal business myself since 1948 so I have 35 years of background experience.

I am on the board of directors of the Pennsylvania Coal Mining Association. I'm a member of its executive committee as well as regional vice president of region 4 of that association which covers 7 coal producing counties in Pennsylvania of which Clearfield is one of them.

The association has 160 producing members who produce more than 60 percent of the entire surface mining production in the State of Pennsylvania on an annual basis. The association also has 125 associate members which provide goods and services to the surface mining industry.

The Pennsylvania Coal Mining Association has long championed the need for amendments clarifying the relevant provisions of the Internal Revenue Code to allow a current deduction for reasonably estimated expenses for the surface mining reclamation.

The original bill was introduced in Congress several years and also had the strong support of our association. We come here today in strong support of Senate bills 1911 and 2642. The major thrust of these bills is to allow the surface mining industry as well as other mineral extractive industries to match expenses and revenue by allowing current deductions for the fixed liability of future reclamation expenses.

Pennsylvania surface coal mining industry is, at the present time, in a terrible economic slump because of weak domestic and international coal markets. Many companies such as my own and mining under 100,000 tons, which are the bulk of the Pennsylvania mining industry, are just barely able to survive. Every month,

more companies are going out of business. The Pennsylvania coal fields are beseiged by chronic unemployment. The coal industry is the key economic synergist in today's heavy unemployment areas. The industry is suffering a very severe cash flow crisis in a time of weak markets and significantly escalating regulatory costs. Any reasonable and sound tax measures which allow surface mining companies such as my own to maximize their cash flow by the sound accounting principles included in these bills are vital to enable our company and many others to survive. We, therefore, support the principles of these bills and the sound tax and accounting doctrines they seek to codify in existing tax laws. We want to express our strong support for the testimony of Mr. Tony Gentile of the Ohio River Collieries Co. who presented testimony on behalf of MARC. As you all are aware, Mr. Gentile's company has just secured a significant decision in the Tax Court in the *Ohio River Collieries* v. *Commissioner* under which the Tax Court only further reaffirmed the propriety of current deductions of reasonably estimated fixed liability for future reclamation expenses.

However, we must point out that the *Ohio River Collieries* case was an anomaly. The IRS stipulated to the reasonableness of the reclamation expenses at issue in that case. In fact, the history of litigation over deductions has been marked by protracted disputes and litigation over the reasonableness of reclamation expenses for coal companies seeking to take this deduction. These controversies impose unnecessary burdens on the courts, the IRS and the taxpayers because they involve valuation issues. The Tax Court has recently expressed its displeasure with the costly and, time consuming adjudication of valuation issues.

We, therefore, urge the committee to consider appropriate steps either in the language of these bills or in the legislative history of these bills to provide a "safe harbor" for coal companies claiming these deductions. The logical safe harbor arises under section 508 of the Surface Mining Control and Reclamation Act of 1977, 30 U.S.C. § 1258. Section 508 requires any coal operator securing a permit to estimate with reasonable accuracy and engineering precision the proposed reclamation cost as part of his reclamation plan. The figure included in the reclamation plan is then used as a basis for a bond that is required under section 509. Because of the self-enforcing nature of this figure, IRS need not worry about any potential for overestimation or abuse. The coal industry will not seek a unnecessarily large deduction at the expense of incurring larger bonding costs. The express recognition in the bill or in the legislative history of this compellingly logical safe harbor under section 508 or the appropriate State legislation where the State is the regulatory authority will eliminate once and for all the protracted litigation and the legal and engineering and accounting costs that arise because of the IRS challenges to the reasonable estimate of our reclamation expenses.

Because the reclamation cost figure included in the reclamation plan must be approved by the OSM or the State regulatory authority and is the basis for the bond amount, this safe harbor is a self-policing mechanism.

We urge the committee to reconsider the need for allowing current deductions of future reclamation expenses for cash basis tax-

payers. In Pennsylvania, there are many small operators who provide a vital and effective role in the surface mining industry who mine under 50,000 tons a year. Many use a cash basis accounting method. It is inequitable and unjust to deny these small operators the vital cash flow relief of these bills.

In conclusion, we hope the committee will support these bills. They provide vital relief for the economically besieged coal industry at a time when weak domestic and international markets and increased regulatory costs have cast a dark cloud over our industry. However, we urge the committee to implement the natural safe harbor provision provided by section 508 of the SMCRA in order to prevent litigation and unnecessary burdens on the courts, the IRS, and the taxpayers that have prevailed in the past. We also urge consideration of the cash basis taxpayer who needs the relief provided by this bill.

Thank you, Mr. Chairman.

Senator WALLOP. Thank you very much, Mr. Penoyer.

[The prepared statement of Robert Penoyer follows:]

**TESTIMONY OF ROBERT PENOYER
SRP COAL CO., INC. ON BEHALF OF THE
PENNSYLVANIA COAL MINING ASSOCIATION**

Mr. Chairman, members of the committee, my name is Robert Penoyer. I am the chief executive officer of SRP Coal Co., Inc. of Clearfield, Pennsylvania. Appearing with me is Stephen Bravermnan of the law firm of Dilworth, Paxson, Kalish and Kauffman of Philadlephia.

SRP Coal Co., Inc. is a surface mining company founded by my father which produces approximately 50,000 tons of bituminous coal annually. I personally have been in the coal business for 35 years starting in the family business in 1948.

I am on the Board of Directors of the Pennsylvania Coal Mining Association and I am a member of its executive committee as well as a regional Vice President of Region 4, a region covering seven coal producing counties including Clearfield County. The Pennsylvania Coal Mining Association has over 160 producing members who produce approximately 60% of the entire surface mining production of Pennsylvania on an annual basis. The Association also has 125 associate companies which provide goods and services to the surface mining coal industry.

PCMA has long championed the need for an amendment clarifying the relevant provisions of the Internal Revenue Code to allow a current deduction for reasonably estimated expenses of surface mining reclamation.[1] The original bills introduced in Congress several years ago had the strong support of our Association. We come here

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1. Section 461(a) of the Internal Revenue Code states that a taxpayer is allowed a deduction in "the taxable year which is the proper taxable year under the method of accounting used in computing taxable income". The regulations provide in section 1.461-1(a)(2) that:

> Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. . . .While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy.

today again in strong support of S.1911 and S.2642. The major thrust of these bills is to allow the surface mining coal industry, as well as other mineral extractive industries, to match expenses and revenue by allowing current deductions for the fixed liability of future reclamation expenses.

The Pennsylvania surface coal mining industry is in a terrible economic slump because of weak domestic and international coal markets. Many companies, especially the smaller companies mining under 100,000 tons, which are the bulk of the Pennsylvania surface mining industry, are barely able to survive. Every month, more companies are going out of business. The Pennsylvania coal fields are besieged by chronic employment. The coal industry is the key economic synergist in today's heavy unemployment areas. The industry is suffering a severe cash flow crisis in a time of weak markets and significantly escalating regulatory costs. Any reasonable and sound tax measures which allow surface mining companies such as SPR Coal Co., Inc. to maximize cash flow by the sound accounting principals included in these bills are vital to enable our company and many others to survive.

We, therefore, support the principals of these bills and the sound tax and accounting doctrines they seek to codify in existing tax laws. We also want to express our strong support for the testimony of Mr. Tony Gentile of Ohio River Colleries Company, Inc. who presented testimony on behalf of the Mining and Reclamation Council of America. As you all are aware, Mr. Gentile's company has just secured a significant decision in the Tax Court in Ohio River Colleries Company, Inc. v. Commissioner[2] in which the Tax Court only further reaffirmed the propriety of current deductions of reasonably estimated fixed liabilities for future reclamation expenses. However, we must point out that the Ohio River Colleries case was an anomaly - the IRS stipulated to the reasonableness of the reclamation expenses at issue in that case. In fact, the history

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2. 77 T.C. 1369 (1981), App. 6/7/82 (USCA 6); App. dismissed.

of litigation over these deductions has been marked by protracted disputes and litigation over the reasonableness of reclamation expenses for coal companies seeking to take the deduction.[3] These controversies impose unnecessary burdens on the courts, the IRS and the taxpayers because they involve valuation issues. The Tax Court has recently expressed its displeasure with the costly, time consuming adjudication valuation issues.[4]

We, therefore, urge the committee to consider appropriate steps either in the language of these bills or in the legislative history of these bills to provide a "safe harbor" for coal companies claiming these deductions. The logical safe harbor arises under §508 of the Surface Mining Control and Reclamation Act of 1977, 30 USC §1258. Section 508 of SMCRA requires any coal operator securing a permit to estimate with reasonably accuracy and engineering precision the proposed reclamation costs as part of the reclamation plan. The figure included in the reclamation plan is then used as the basis for the bond required by §509 of SMCRA. Because of the self-enforcing nature of this figure, IRS need not worry about any potential for overestimation or abuse. The coal industry will not seek an unnecessarily large deduction at the expense of incurring larger bonding costs. The express recognition in the bill or in the legislative history of this compellingly logical safe harbor under §508 of SMCRA or the appropriate state legislation where the state is the regulatory authority, will eliminate once and for all the protracted litigation and the legal, engineering and accounting costs that arise because of IRS challenges to the reasonable estimate of reclamation expenses. Because the reclamation cost figure included in the reclamation plan must be approved by OSM or the

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3. See Denise Coal Company v. Commissioner 271 F.2d 930 (3d Cir. 1959) and Harrold v. Commissioner 192 F.2d 1002 (4th Cir. 1951) involving coal reclamation costs.

It is doubtful, in our view, that the IRS will again stipulate to the reasonableness of the estimate as it did in the Ohio River case. Even the Tax Court expressed surprise that the government stipulated so much. 77 T.C. 1369 at 1374.

4. Buffalo Tool & Die Manufacturing Co., Inc. et al. v. Commissioner, 74 T.C. 441, 451-52 (1980).

state regulatory authority and is the basis for the bond amount, this safe harbor is a self-policing mechanism.

We also urge the committee to reconsider the need for allowing current deductions of future reclamation expenses for cash basis taxpayers. This recognition is not provided in either bill, S.1911 or in S.2642. In Pennsylvania, there are many small operators who provide a vital and effective role in the surface mining industry who mine under 50,000 tons a year. Many use a cash basis accounting method. It is inequitable and unjust to deny these small operators

In conclusion, we hope the committee will support these bills. They provide vital relief for the economically besieged coal industry at a time when weak domestic and international markets and increased regulatory costs have cast a dark cloud over the industry. However, we urge the committee to implement the natural safe harbor provision provided by Section 508 of SMCRA in order to prevent litigation and unnecessary burdens on the courts, IRS, and the taxpayers that have prevailed in the past. We also urge consideration of the cash basis taxpayers who need the relief provided by this bill. We thank you for your time and are available for any questions.

STATEMENT OF W. H. ROSE, TAX DIRECTOR AND ASSISTANT SECRETARY, ARCH MINERAL CORP., ST. LOUIS, MO.

Senator WALLOP. Mr. Rose.

Mr. ROSE. Mr. Chairman, my name is William Rose. I am appearing here today in my capacity as tax director and assistant secretary of Arch Mineral Corp. I thank you for this opportunity to express our views with respect to this legislation. Arch Mineral Corp. is 1 of the 20 largest coal producers in the United States. It operates surface mines in the States of Alabama, Illinois, and Wyoming.

This legislation is important to Arch Mineral Corp. and the entire mining industry. The coal mining industry, as you have heard, is currently experiencing a severe recession and at this time of economic hardship the aspect of prolonged controversy with the Internal Revenue Service over the ability to deduct accrued reclamation can lead to the closing of marginally profitable mines and possibly even a postponement of the opening of new mines. Once the decision is made to open a new mine or reopen one that has been closed, there is a significant lead time before the mines will begin producing. Because of the period of time needed to bring a mine to the producing stage, the closing of a mine and the delay in the opening of new mines will possibly result in energy shortages at a future date when there is an expansion of the demand for coal.

The legislation will codify the existing law and eliminate prolonged controversies with the Internal Revenue Service.

Pursuant to the requirements of both Federal and State law, a coal mine operator is liable for the expenses of reclaiming the land disturbed by mining. This liability is imposed immediately at the time the land is disturbed by the mining process. Modern engineering techniques allow coal operators to accurately compute the costs of restoring the land that is disturbed. As a result, we feel that both tests provided by the regulations adopted under section 461 of the Internal Revenue Code are met, and that the expenses accrued for the cost of reclaiming are deductible expenses for the tax period in which the disturbance of the land occurs.

In addition to the two circuits which have specifically sided with coal operators in the *Harrold* and *Denise* cases, several other circuits have also sided with taxpayers on this issue, when the issue has been raised in connection with accrued expenses other than accrued reclamation. Recently the Tax Court in the *Ohio River Collieries* has also sided with the coal operators.

The published statement of the position, that the Internal Revenue Service has taken with respect to this matter, is set out in National Office Technical Advice Memorandum No. 7831003. As an indication of the lack of support for the position taken by the Internal Revenue Service, this memorandum cites only one case in support of their position, that is not a Tax Court case or a case decided since the *Harrold* decision in 1951. The cited case, *Schlude* v. *Commissioner,* deals with prepaid income and not accrued expenses, and in our opinion it is not on point with the issue. Of course, the Tax Court decisions cited by the Internal Revenue Service in this memorandum have been specifically overruled in *Ohio River Collieries.*

I think that for the good of the coal industry and the country as a whole, it is important that this legislation be adopted. Two potential problems are not addressed by this legislation, however. One of these is the removal of current disputes from controversy, and the second of these deals with guidelines as to what constitutes a reasonable estimate of the liability.

With all due respect, I would like to suggest that both of these problems could be addressed in the committee report. A statement to the effect that the guidelines set forth in this bill are to be used in settling current disputes would be useful. In addition, I think it would be proper to include a statement in the committee report that unless the Commissioner is able to determine otherwise, it shall be presumed that the liabilities accrued by the taxpayer for reclamation expenses is computed with reasonable accuracy. I don't think that such a presumption would be unreasonable in view of the large amount of time and money which coal operators devote to the determination of this accrual.

Once again, I thank you for this opportunity to let our views be known.

Senator WALLOP. Thank you, Mr. Rose.

[The prepared statement of W. H. Rose follows:]

TESTIMONY OF

WILLIAM H. ROSE

WITH RESPECT TO

THE MINING RECLAMATION RESERVE ACT OF 1981 (S.1911)

AND

THE COMPREHENSIVE MINING RECLAMATION ACT OF 1932 (S.2642)

My name is William H. Rose. I am a member of the Missouri Bar Association and Chairman of the National Coal Association's Ad Hoc Tax Committee on Accrued Reclamation. I am appearing in my capacity as Tax Director and Assistant Secretary of Arch Mineral Corporation ("Arch"). Arch is among the twenty largest coal producers in the United States. It operates surface mines in the states of Alabama, Illinois and Wyoming. I thank you for this opportunity to express these views with respect to the Mining Reclamation Reserve Act of 1981 (S.1911), proposed by Senator Specter, and the Comprehensive Mining Reclamation Act of 1982 (S.2642), proposed by Senator Wallop.

This legislation is important to Arch and the entire coal mining industry. The coal mining industry is currently experiencing a recession. The prospect of a prolonged controversy with the Internal Revenue Service over the ability to deduct accrued reclamation expenses would contribute to the present economic difficulties in the coal mining industry.

The legislation under consideration will clarify the existing law, thereby eliminating unnecessary tax controversies between coal producers and the Internal Revenue Service ("Service"). Accrual deductions are provided for in 1954 I.R.C. Section 461. Section 1.461-1(a)(2) of the Treasury Regulations ("Regs.") provides that an accrual basis taxpayer shall recognize a deductible expense in the tax year in which:

(1) All events have occurred which determine the fact of the liability, and

(2) The amount of the liability can be determined with reasonable accuracy.

Federal and state laws require coal mine operators to reclaim land disturbed by mining. This liability is imposed at the time the land is disturbed. Coal operators have the engineering expertise to accurately compute reclamation costs. Thus, coal operators have the ability to meet the tests required by the Regs. Unfortunately, the Service is presently contending that coal operators cannot comply with these tests until the reclamation work is completed.

There is overwhelming judicial authority for the taxpayer's position [Harrold v. Commissioner, 192 F. 2nd 1002 (4th Cir. 1951) and Denise Coal Co. v. Commissioner, 271 F. 2nd 930 (3rd Cir. 1959)]. Several other circuits have similarly sided with the taxpayers on this issue involving accrued expenses other than reclamation. Recently the Tax Court in Ohio River

Collieries Co. v. Commissioner, 77 T.C. No. 103 (12/31/81) held for the taxpayer.

The Service position is stated in the National Office Technical Advice Memorandum #7831003. As evidence of the paucity of authority for the Service's position, this memorandum cites only one appellate court decision (Schlude v. Commissioner, 372 U.S. 128 (1963), which has been rendered since the Harrold case (supra) was decided. The Schlude case does not address similar issues as it pertains to prepaid income. Earlier Tax Court decisions cited by the Service have been overruled in Ohio River Collieries, supra. The Treasury Department has decided not to appeal the Ohio River Collieries decision.

Notwithstanding the dearth of authority supporting their position, the Service continues to disallow deductions for accrual of reclamation costs. Apparently, the Service is continuing to pursue and litigate this position in the hope of future favorable court decisions. The likelihood of such a court decision is remote.

Two potential problems not addressed by this legislation should be addressed in the Committee Report. The report should state that current disputes be settled by utilizing the standards in the legislation. Further, the report should state that unless the Commissioner is able to determine otherwise, it shall be presumed that the liability accrued by the taxpayer for reclamation expenses is computed with reasonable accuracy. Such a presumption is reasonable in view of the extensive resources utilized by coal mine operators in the determination of this accrual.

Once again, I thank you for this opportunity to make our views known.

Mr. BRAVERMNAN. Mr. Chairman, I have a remark.

Senator WALLOP. Well, I would point out, Mr. Penoyer, that both the Specter and Wallop bills do address the issue of cash accounting taxpayers. I think that we have developed this morning, at least, a very sound case on behalf of the industry, and I am less impressed with the expressed case of Treasury. I understand their worry about the precedent of this slopping over into other areas. But it seems to me with the Tax Court's decision on the books and the other court decisions on the books that that precedent is much more expansive in its potential left that way than it would be if we were to pass legislation such as this with some clear definition as to what it was we were trying to get accomplished. And that's a piece of negotiation that I will undertake with them later.

But I can't believe that the precedent isn't more expansive rather than less expansive, leaving it unaddressed in the statutes.

I appreciate your taking time to come here even if you didn't travel as far as from Cleveland. [Laughter.]

It's been helpful to me and to the committee. And we will see what we can get done. I appreciate it.

The committee will stand adjourned.

[Whereupon, at 12:01 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Deloitte
Haskins + Sells

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(303) 534-8153
Cable DEHANDS

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D.C. 20510

December 9, 1982

Dear Mr. Lighthizer:

We are pleased to have the opportunity to comment on Senate Bill 1911 and Senate Bill 2642, presently under consideration by the Senate Finance Committee. Deloitte Haskins & Sells, an international accounting firm, has extensive experience in serving the mining industry.

We believe both of these bills provide much needed codification of rules for determining the proper taxable years in which mineral-extracting taxpayers may deduct reclamation costs. Senate Bill 1911 would allow a deduction for reasonable estimates of reclamation costs allocable to minerals extracted by surface mining activities before the close of the taxable year. Senate Bill 2642 would allow taxpayers to choose between two methods for deducting reclamation costs. The first method under Senate Bill 2642 is the same as that provided under Senate Bill 1911. The second method under Senate Bill 2642 would allow a deduction for reasonable estimates for reclamation costs allocable to the portion of the property disturbed by surface mining before the close of the taxable year.

We favor the passage of Senate Bill 2642 because:

- the Treasury's own regulations provide for the deductibility of properly accruable expenses,
- courts have overturned Treasury attempts to disallow deductions for accrued reclamation costs,
- the concern over restoration of the natural environment has led to legislation requiring those in the extractive industries to restore the landscape altered by extractive processes. This tax legislation would assist the extractive industries to be more certain of their ability to comply, and
- the nation's stability and security is well served by measures which allow the mining industry to maintain its viability.

We favor Senate Bill 2642 because of the added flexibility it would offer taxpayers in calculating their deduction for reclamation costs. The method under Senate Bill 2642 allowing a taxpayer an option to deduct reclamation costs at the beginning of a mining project when property is disturbed would be similar to provisions under section 616, IRC, which allow a current deduction for mine development costs, unless an election is made to capitalize such costs. In addition, Senate Bill 2642 would allow a taxpayer to deduct reclamation costs at the point in time when the liability for those costs is incurred (that is, as soon as land is disturbed), which is the proper time for accrual-basis taxpayers to deduct these costs according to existing Treasury regulations and court cases.

The Treasury regulations provide two tests which must be met for an accrual-basis taxpayer to accrue an expense for tax purposes. First, all the events which establish the fact of the liability must have occurred in the taxable year when the deduction is sought. Second, the amount of the liability must be determined with reasonable accuracy. With regard to reclamation expenses, in most cases both these tests are met before the reclamation process actually takes place.

Most mineral-extracting taxpayers are strictly bound by state statutes to restore any land on which they mine to its original (sometimes better-than-original) condition. Usually the taxpayer is required to make very extensive estimates of the reclamation costs. In most cases the taxpayer must post bonds for performance of the reclamation requirements and must remain liable for additional costs over and above the bonds posted. If the taxpayer fails to comply with the requirements of the statute, the state usually has the authority to discontinue the taxpayer's extractive operations.

In addition to state reclamation statutes, the Federal government has enacted the Surface Mining Control and Reclamation Act of 1977. This Act provides for the cooperation between the Secretary of Interior and the states with respect to regulation of surface coal mining operations. The Act provides that the primary responsibility for controlling the reclamation operations lies with the individual states. However, if the states fail to carry out this responsibility, the Act grants the Federal government the power to ensure the protection of the public interest through control of surface mining operations.

Because of such legislation, it is clear that mining taxpayers incur a definite, unavoidable obligation, or liability, to restore any land that has been altered by their extraction operations. Such liability occurs as soon as the land has been disturbed. Even if the taxpayer ends up not mining any mineral, or after mining, is unable to sell any mineral, the liability is still there to incur the reclamation costs.

With respect to the second test, it is a question of fact as to whether the amount of the expense can be determined with reasonable accuracy. Even where the entire expenditure cannot be determined with reasonable accuracy, the regulations provide that the portion which can be determined with reasonable accuracy is accruable. These bills would provide for deduction of expenses which can be estimated with reasonable accuracy.

In past situations where the Internal Revenue Service has challenged a deduction for accrued reclamation costs, the courts have agreed with the mineral-extracting taxpayer that the requirements of the Treasury regulations were met, provided the liability was fixed and the taxpayer used diligent methods of estimating the costs. The Treasury's position in attempting to disallow reclamation expenses is inconsistent with their own regulations and results in arbitrarily imposing cash-basis accounting on accrual-basis taxpayers. Nonetheless, the Internal Revenue Service has continued to challenge taxpayers' deductions for accrued reclamation costs, thereby creating a controversy concerning the proper time for deducting these costs.

This controversy has created an atmosphere of uncertainty in planning mining projects, which has undermined the economic health of an industry which already has been hard hit by the recent economic recession. By its very nature, our nation's mining industry is a very high-risk business requiring substantial capital outlays at the front end of its mining projects. Normally there is a significant development phase before any of the capital outlays can be recouped from mineral sales. These high initial capital requirements coupled with a long lag time before minerals are sold causes severe cash-flow shortages in the mining industry. In addition, recent high interest rates have placed further cash-flow burdens on mining taxpayers causing numerous companies to shut down operations. Senate Bill 2642 would eliminate the controversy surrounding the proper time for deducting reclamation costs, thereby reducing the uncertainties associated with planning mining projects, which will in turn help stimulate economic recovery in this industry. We also believe Senate Bill 2642 would help alleviate the depressed state of our nation's mining industry by allowing taxpayers to offset the risks associated with investing in mining operations by the increased cash flow which will result from the reclamation deductions provided in this bill.

At hearings on December 7, the Treasury presented the view that an accrual deduction is unfair because it gives the taxpayer the benefit of a deduction prior to the outlay of cash and made arguments based upon time-value of money and discounted cash flow projections. Such an argument runs contrary to the theory of accrual tax accounting and the whole

thrust of the Internal Revenue Code. Under the current law, taxpayers must in many instances recognize income prior to receipt. In addition they are precluded from immediate deduction for expenditures made; for example, machinery and equipment, buildings, and goodwill. Fixed and determinable liabilities are allowable as deductions under the Internal Revenue Code without regard to the date of payment except in special situations such as section 267.

In summary, we support the enactment of Senate Bill 2642. It would eliminate the current controversy caused by the Internal Revenue Service taking a position that is in conflict with cases and with the Treasury regulations and would provide a substantial boost to a crippled industry which supplies our nation with critical raw minerals.

We appreciate the opportunity to be able to provide these comments to the Energy and Agricultural Taxation Subcommittee of the Senate Finance Committee. Should you have any questions, please call me at (303)534-8153.

Yours very truly,

James R. Cummings

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December 14, 1982

SENATE FINANCE SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

HEARINGS ON BILLS S. 1911 AND S. 2642
TO PERMIT THE ESTABLISHMENT OF
MINING RECLAMATION RESERVES

STATEMENT FOR THE RECORD BY
COOPERS & LYBRAND

Coopers & Lybrand is an international public accounting firm with over 350 offices in 90 countries. We have numerous clients who are involved in one aspect or another of the domestic mining industry.

We appreciate this opportunity to submit for the record this statement on the proposal to provide for the establishment of reserves for mining land reclamation and for the deduction for tax purposes of amounts added to such reserves, as set out in Bills S. 1911 and (with additional language) S. 2642.

We believe that the proposed legislation in S. 2642 should be approved by this Committee.

It is important to recognize that this legislation is not granting a new deduction. Rather, it is clarifying a controversy between taxpayers and the Internal Revenue Service as to the time for taking that deduction. That controversy is one in which the taxpayer, upon reaching the ultimate judicial forum, has consistently won the day, except where the estimate of the reserve was not shown to be a reasonable one. This legislation would codify those judicial decisions while retaining the requirement

that the estimated reserve be reasonable. The absence of such legislation encourages future litigation with its attendant unproductive costs and further strain on an already overtaxed judicial system. This legislation would end litigation unjustified by consistent judicial precedent to the contrary and to that end we would support its passage.

Discussion

Present income tax rules provide a two-part test to determine when an expense is deductible under the accrual method of accounting, namely:

1. have all events occurred which determine the fact of the liability; and

2. can the amount thereof be determined with reasonable accuracy.

In respect of part one of the test (have all events occurred which determine the fact of the liability) as it applies to reclamation reserves, the Internal Revenue Service takes a position which runs counter to a long line of cases*. Broadly, the Internal Revenue Service position is that, although there may be a statutory obligation to reclaim stripped land, it is: (a) an obligation only to incur an expense at some time in the future, and (b) such

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* See, for example, the following cases which were all decided in the taxpayer's favor on the issue of whether all events had occurred to determine the fact of the liability:

Denise Coal Co. v. Commissioner, 271 F.2d 930 (3rd Cir. 1959);
Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951);
Patsch v. Commissioner, 208 F.2d 532 (3rd Cir. 1953);
Jenkins v. Commissioner, 217 F.2d 951 (3rd Cir. 1955);
Commissioner v. Gregory Run Coal Co. 212 F.2d 52 (4th Cir. 1954);
Ohio River Collieries Co. v. Commissioner, 77 TC 1369 (1981).

obligation is contingent upon performance. The courts have, however, accepted that the statutory obligation, which generally requires the posting of forfeitable bonds, is a fixed and definite obligation, for which a tax deduction should be allowed if the amount can be reasonably determined.

Inasmuch as the proposed legislation makes it clear that a deduction will be allowed, subject to determining what is a reasonable estimate, it should resolve this conflict. This will be of obvious benefit in terms of avoiding time consuming and costly litigation.

As for part two of the test (can the amount of the liability be determined with reasonable accuracy), the Internal Revenue Service position appears to be that all facts which fix the amount of the liability must be known or knowable during the year. Although this does not necessarily mean that the exact amount be known, the Internal Revenue Service has not agreed to follow the "reasonable estimate" approach adopted by several courts.

The proposed legislation should resolve the finer points of this issue, insofar as it requires that a reasonable addition to a reserve for estimated expenses of reclamation shall be allowed.

In summary, we welcome the recognition, by this legislation, that the mining industry has a definite obligation, arising out of day-to-day operations, to reclaim stripped land and that the industry should be allowed to establish a tax deductible reserve for the estimated costs associated with this obligation so as to properly match the expense with the income generated thereby.

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CHRIS FARRAND
VICE PRESIDENT
GOVERNMENT RELATIONS

December 14, 1982

The Honorable Malcolm Wallop
Chairman, Subcommittee on Energy
and Agricultural Taxation,
Committee on Finance
United States Senate
2227 Dirksen Senate Office Bldg.
Washington D. C. 20510

Dear Mr. Chairman:

Peabody Coal Company, the nation's largest coal producer, wishes to provide for the record written testimony in support of S. 1911 and S. 2642, legislation now before your Subcommittee to amend the Internal Revenue Code to permit the accrual of mined land reclamation costs as an expense for tax purposes.

The mining industry has always assumed that an operator should accrue estimated expenses of reclamation as the mining operation progressed. As support for that contention, the reclamation and restoration of lands as contained in the Surface Mining Control and Reclamation Act of 1977. An operator must submit detailed reclamation plans, provide for performance bonds or show financial responsibility. States in which surface mining is prevalent also impose similar requirements, including the posting of surety bonds equal to the total estimated cost of reclamation.

The Internal Revenue Service's long-standing position has been and is that the accrual of an expense for tax purposes must meet the criteria imposed by Section 461 of the Internal Revenue Code, commonly referred to as the "all events test".

The all events test for accrual of an expense encompasses the following subjective criteria:

-- the fact of the liability must be established

-- the amount of the liability can be determined with reasonable accuracy (emphasis added)

Based on the above criteria, the mining industry believes that the accrual and deductibility of costs associated with reclamation is justified under existing law. This belief is further supported by decisions rendered by the 3rd and 4th U.S. Circuit Courts of Appeal wherein the issue of estimation with reasonable accuracy was addressed. The Court allowed the deductibility of accrued amounts where reasonable means of estimation were deemed to exist.

Subsequent to these decisions, the Internal Revenue Service issued in 1978 a Technical Advice Memorandum which did not follow these line of cases. The IRS has taken the position that the accrual of reclamation expense should be delayed to that year in which the reclamation is performed, which in essence equates to cash basis tax accounting.

Since the issuance of the Technical Advice Memorandum, the Tax Court has once again addressed the issue of deductibility of accrued reclamation expenses in Ohio River Collieries v. Commissioner, 77 T.C. 103 (1981) and found in favor of the taxpayer. The Government stipulated in this case that the taxpayer's estimation of its cost of reclamation was reasonable and was therefore not at issue. The Government's entire case rested on a showing that the fact of the liability had not been established. The Court, in its opinion, stated that "Such an argument, however, flies in the face of the reality of the Ohio law, which requires the strip-miner to estimate his reclamation cost and post a surety bond to cover it. Accordingly, once these two acts have been performed followed by a third, the intended strip-mining, the liability becomes certain".

The Appellate Court decisions and the Ohio River Collieries case clearly indicate that liability exists at the moment that overburden is removed and the fact that the accrued liability is based upon an estimate of costs does not defeat deductibility provided that the estimate is reasonable.

We believe that the operator has a clear liability and obligation to restore that land disturbed in a strip mining operation and that we have no recourse but to ultimately liquidate that obligation. Furthermore, the estimation of the cost to liquidate that obligation must be agreed to by at least three independent parties: the federal and state agencies charged with the responsibility of approving a mining and reclamation plan, including quantifying the amount of the surety bond; our public accountants who must judge the adequacy of the reclamation reserve for financial statemant purposes; and our customers who are subject to contract escalation clauses permitting adjustments to the sales price of coal for increases in accrued reclamation costs.

Peabody Coal Company urges prompt approval of S. 1911 in order to codify existing case law and eliminate the uncertainty resulting from the inconsistent position taken by the Internal Revenue Service. There remains no doubt that the liability for reclamation exists. It is made certain by law. The amount of the liability is confirmed by the bonding requirements, well within the criteria established by the Internal Revenue Code. And there is no question that the liability exists at the time the mining is conducted. Nevertheless, the Service has taken a position which appears inconsistent with the law and judicial interpretation of the law. We therefore look to this Subcommittee and to the Congress to provide the necessary clarification by adopting the provisions of S. 1911 and S. 2642.

Sincerely,

PEABODY COAL COMPANY

Chris Farrand

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Vice President
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